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A Critical Analysis of Iranian Buy-Back Transactions in the Context of International Petroleum Contractual Systems

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Part Three: Comparative Perspectives on Iranian Oil Contracts in Light of International Concerns

Introduction

In the increasingly tense atmosphere of relations between Iran and the international community, headed by the United States, an often overlooked aspect is the effect of such conflicts on Iran's oil industry and, consequentially, the global oil situation. In the current environment of increasing oil prices, with the price of oil per gallon almost reaching triple digits, the effects of such pressure on Iran's oil industry therefore have ramifications for the entirety of the world economy, which is heavily dependent on petroleum products.

Consequently, Part Three of the study attempts to deduce the effects of the continuing tensions in relation to Iran on its oil industry, by juxtaposing two opposing factors whose interaction will result in the shaping of the final outcome within the oil market: attractiveness of Iranian buy-back in relation to similar contractual systems on one hand, and the disincentives resulting from US pressure on the other. In addition to the analysis of the advantages and disadvantages of the Iranian buy-back system from the perspectives of foreign and domestic parties, provided above, it is vital to assess the comparative strengths of the Iranian interpretation of buy-back in relation to the mainstream version; as increasing economic and political pressure on the Iranian oil sector is likely to compel the adoption of such mainstream elements in order to increase the attractiveness and competitiveness of Iranian oil. This comparative study is undertaken in a categorised manner that permits effortless comparison between Iranian and standard international buy-back model, with the ability to easily locate elements of the mainstream model that may be adopted by Iran in pursuance of investors. Additionally, as historical and legal factors often necessitate the adoption of comparatively more stringent provisions within the Iranian context, such factors are examined in order to assess the probability of a more liberal, international model

within each contract category. The analysis therefore permits predictions to be made regarding the potential for increasing the attractiveness of Iranian buy-back, as one of the factors constituting the juxtaposition.

The other relevant factor is the extent of pressure exerted in the past and likely to be exerted in the future by the US and the international community; since as disincentives due to sanctions and political pressure on oil companies increase, the relative attractiveness of Iranian buy-back must increase correspondingly in order to ensure continued attraction of foreign oil production companies. The historical and political motivations for such measures, particularly within the United States, are reviewed so as to gauge the extent to which changes in political circumstances may lead to the harshening of sanctions and political pressure on Iran's petroleum industry. Furthermore, the provisions of the relevant legislation giving effect to sanctions are examined in order to determine the extent to which they are effective, particularly in view of actual economic deterrence as evidenced by foreign oil firm involvement in Iran. Lastly, the effects of such sanctions, far-reaching by their nature, are examined to determine the viability of their continuation, particularly with reference to effects on the global scale and the interplay of the world's major economic powers.

Such an extensive examination of the international political situation as it affects Iran's petroleum industry is warranted, particularly in the light of the most recent developments in this area. Amongst such events is the European Union's official proclamation of belief in the need and necessity of sanctions, particularly targeting Iran's petroleum and financial industries. The potential economic effect of such sanctions originating in the European Union, considering the number of European companies involved within Iran, may be enormous and have consequences for the global distribution of economic power; particularly resulting in Iran's oil sector being dominated by Chinese and Indian companies not bound by such sanctions. The likelihood of

such an outcome, and the necessity for considering the effects of such developments, is further illustrated by the British Prime Minister, Gordon Brown's, 12th November 2007 statement: "We will lead in seeking tougher sanctions both at the U.N. and in the European Union, including on oil and gas investment and the financial sector".⁴²²

⁴²² Reuters, 12th November 2007 [<http://uk.reuters.com/article/domesticNews/idUKL1270031520071112>]

Chapter 7: Comparative Analysis of Iranian and International Model Buy-Back

7.1 Introduction

An essential component of analysing the strengths and weaknesses of contractual systems is the comparison with alternative systems seeking to achieve the same commercial goals. As a broader comparative analysis of buy-back schemes and alternative licensing agreements, such as PSA and Joint ventures, has already been conducted, it is therefore appropriate to conduct a narrower analysis. As Iran's interpretation of buy-back agreements is based on the particular political and economic environment of that country, it does not conform entirely to the more generic international schemes of this type. Considering the extent to which foreign participants criticise numerous aspects of the Iranian buy-back scheme and considering that the scheme is merely an interpretation of the International model contract, it is now vital to provide a comparative analysis of the relative strengths and weaknesses of the two systems in order to fully assess the Iranian scheme. Consequently, the extent of these differences and their likely effect on the attractiveness of Iranian buy-back agreements must be determined through such a side-by-side comparison.

For the above reasons, following a description and analysis of the legal basis and procedures related to the generic buy-back scheme, it is necessary to place this information into a more pragmatic context, namely through an examination of an actual such agreements. The contracts used for this comparison are representative of the general nature of such agreements. The Iranian licensing agreement to be examined is one of the early specimens of buy-back, specifically the 1999 Paydar West Field Asmari and Bangestan Reservoirs licensing agreement with the South

Fields section of the National Iranian Oil Company.⁴²³ Its international equivalent is the more generic agreement formulated by the United Nations Economic Commission for Europe. The terms of the aforementioned contracts will therefore be selectively⁴²⁴ described and analysed according to the matter to which they pertain, with pertinent information included in footnotes so as to enhance this comparison.

7.2 Preliminary Contractual Terms

Before attempting to discuss the more complicated areas of the contractual framework, the interpretations of which are often subject to intense scrutiny, it is first appropriate to consider the basic terms and conditions of the buy-back standard model. These can be divided into two areas: that of the delineation of services and responsibilities, outlining the role that each party is expected to take in the contract; and that of the contract's duration, dealing with prescribed periods and the various responsibilities and ownership rights once the contract has reached its full term.

7.2.1 Delineation of Services and Responsibilities

As the basis of any contract is the delineation of the scope of each party's responsibilities, it is therefore necessary to begin the analysis of this sample contract with the means by which both the domestic and the International contracts deal with the delineation of responsibilities between the parties. As the International version provides a more general conceptual starting point for an analysis, its relevant provisions will be reviewed first.

⁴²³ Ule, C. and Brexendorff, A. *op.cit.*, p. 39-40

⁴²⁴ The provisions that are most significant for a comparative analysis will be examined, although the full texts of both the Iranian and the International model contracts are available in the Appendix.

Transactions and obligations contained within the primary agreement as well as the technological aid agreements, are shown in the ‘whereas’ clause of the International contract. This briefly reviews the contract history leading to the buy-back contract. The clause states that whereas under a Primary Contract⁴²⁵ finalised on a specific date and the Technical Assistance Contract finalised on a specific date, the seller (designated within the Model Contract as X)⁴²⁶ has sold to the buyer (similarly designated as Y), and the buyer⁴²⁷ bought from the seller, as per the provisions of the relevant contracts, including any materials or expertise outlined within,⁴²⁸ to manufacture products⁴²⁹ in the buyer’s land.

On the basis of this the parties therefore agree to the buy-back contract and a series of terms in the form of articles follows. This history of previous dealings related to the buy-back highlights information relevant to the instant contract. It also establishes a course of dealing.

Article 1.1 states that the seller⁴³⁰ will consent to purchase or initiate another party’s purchase,⁴³¹ as per the contractual provisions, of the buyer’s output resulting from the utilisation of the technology provided by the seller, as well as to accept the output upon delivery.⁴³²

Article 1.2 states that the buyer will agree to sell to the seller or a party assigned by him, according to the wording of Article 6 and related provisions, as well as to allow the buying of the output by the seller, in the form of buy-back.

⁴²⁵ A Primary Contract is the contract dictating the rights and obligations of the parties which pertain to the supply of the equipment/technology.

⁴²⁶ In this case, X is the original the seller, the supplier of the equipment/technology under the primary contract.

⁴²⁷ In this case, Y is the original the buyer, the purchaser of the equipment/technology under the primary contract.

⁴²⁸ Hereinafter known as “the equipment technology”

⁴²⁹ Products are the items or material sold and bought through the Buy-Back contract, produced by the equipment/technology from the primary contract.

⁴³⁰ In this scenario, X is the Buy-Back purchaser, who is the the seller under the primary contract, in their capacity as the buyer under the Buy-Back contract.

⁴³¹ In this case, Y is the Buy-Back the seller, and therefore the the buyer under the primary contract, in their capacity as the seller under the Buy-Back contract

⁴³² Equipment/technology consists of the machinery, equipment, patents, knowledge, and/or technical assistance that will permit the production of the end product.

Article 1 establishes the very basic rules of the contract, establishing a valid condition for each party subject to proceeding articles. The condition of the seller is a promise to buy products and the condition of the buyer is a promise to sell products. In addition to this it is necessary to identify terms relating to the description, quality and quantity of the goods as well as establishing rules over time of delivery. As the range of products or services involved in buy-back is extensive, the International contract is correct to remain deliberately vague in this area in order to permit maximum latitude to the parties in a concrete situation to decide on the scope of services and obligations.

Comparatively, Article 2 of the domestic scheme provides a more specific list of responsibilities and rights, including the assignment of expenses and profits as well as the risks of not finding oil in the designated area. Such an approach is consistent with the idea of the International scheme as it focuses on the issues on the ground and adds the specific terms and conditions required for the operation in question. A clear and precise division of responsibilities also decreases the chance of arbitration over vague terms in the future, as well as enhancing the legal certainty and trust placed in such a contractual arrangement.

The terms of Article 2 are as follows:

“Contractor responsible to NIOC for operations and is to provide all capital, technology and skills necessary for the conduct of Development Operations for this Contract, and shall bear the Petroleum Costs required in carrying out Development Operations, and to recover such costs as provided in Clause 22 hereof, and bear the risks that sufficient production additional production

of Crude Oil, and or Natural Gas may not be produced from the Contract Area in order to recover all such Petroleum Costs.”⁴³³

The terms place the risks and costs squarely on the shoulders of the foreign company. Although given that the risks associated with the exploration of oil fields are all but non-existent this is not at all onerous to the foreign investor.

7.2.2 Issues of Contractual Duration and Prescribed Periods

Issues of time schedules and contractual length are especially important in a highly structured contractual environment, such as the buy-back, where obligations and remuneration is contingent on the performance of duties within specific time frames. Since buy-back as portrayed in the International scheme is more product-oriented, significantly more attention is given to the time frames within which such products must be produced and the repercussions for failing to produce them within the time given.

Article 10 governs the very important issue of the schedules for performance of obligations under the contract. Failure to comply with the time schedules for contractual obligations is likely to result in action against the breaching party with remedies available dependant on Article 14 and the jurisdiction in which a case is tried should it reach court.

According to Article 10.1, the supply of the output by the buyer begins following an initial hiatus period of days or months after the conclusion of any output efficiency trials, as well as the acquiescence to accepting the technological materials. .

⁴³³ The translations of the Articles discussed in this section have been taken from Dr. Ule and Dr. Brexendorff's work on the issue.

Article 10.2 prescribes the use of a detailed time plan, prescribing the completion of various commitments at varied stages and time frames.

As per Article 10.4, following the conclusion of negotiation pertaining to the size and type of output, the seller's various responsibilities and related issues, the extent of the seller's need for the output will be accounted for, as will the contemporaneous conditions of the market within the relevant area. Until all of the responsibilities on both sides of the contract have been discharged, the price of output that is sold will be based on a fixed value negotiated by the parties.

Article 10.5 states that sufficient Implementing Contracts to cover the whole of the seller's buy-back obligation as agreed under paragraph 4.1 above, must be concluded by a fixed date negotiated between the parties.

Article 10 must be clear and concise as breach of terms relating to delivery time and value of goods can have considerable ramifications for a breaching and innocent parties. In this kind of international trade, especially on a volatile commodities market where string trading is common the breach of delivery time will often lead to failure to meet re-sales.

Article 9 specifies that the conditions for the supply of the output, such as the time scale and the location, will be negotiated in each separate instance.⁴³⁴

As is clear from the above Articles, timely deliveries of the products concerned are of primary importance for the International scheme, with significant emphasis being placed on the consequences of late delivery and less attention given to the duration of the actual contract as a whole. This element differs from an Iranian buy-back scheme as issues of contractual duration are of primary and vital importance to any extensive and high-investment project such as oil

⁴³⁴ Usually either F.O.B. or C.I.F.

development, as significant initial cost output is required prior to the period during which sufficient oil is being produced in order to reap the financial rewards. An overly short permitted production time may result in a lack of interest from foreign investors due to the limited scope for profit, whereas overly long durations may lead to allegations of ‘concessions’ and 19th-century exploitation.

The most crucial of these temporal provisions is Article 3, prescribing the general duration of the contract. The clause is obviously negotiable, as the duration of a buy-back contract will vary depending on the specific circumstances of the deal. Buy-back contracts tend to be short term,⁴³⁵ in the region of five years, as opposed to PSAs which tend to be much longer term agreements.

Article 3.1 states that:

NIOC hereby authorizes Contractor to conduct development Operations in the end of the Development Phase in (To Be Negotiated) field. The conclusion of the Development Phase, under the Master Development Plan, for (To Be Negotiated) Field is (To Be Negotiated) months, unless extended by mutual agreement.

The Article below illustrates the fairly high-risk nature of buy-back in its current form to the foreign parties, as Article 3.3 provides that the extent to which the compensation amount as well as the remuneration will be repaid through oil production is limited through the time specified in this clause. Consequently, if a radical dip in oil prices occurs, this time limitation may ensure that the IOC will not only recover its remuneration but also be unable to cover its costs, while the NIOC may utilise a different production company so as to reap the benefits of the field once the prices rise again, without the need to fully compensate the original producer.

⁴³⁵ Due to policy limitations set out by the Oil Ministry, rather than any commercially conscious decision.

Article 3.3 states that:

This Contract shall commence on the Effective Date, and shall continue through the Development Phase and thereafter until Contractor has recovered all Petroleum Costs and remuneration fee in accordance with Clause 22 ... which period shall not exceed (To Be Negotiated) years from the date on which ... Field has commenced first/additional production, unless extended by agreement.

Therefore, Iranian buy-back contracts, due to their subject matter of oil, which is not delivered as traditional goods are, in distinct shipments, but rather constantly sent through pipelines, concentrate on the contractual duration issue rather than the problem of specific deliveries. This is not to say, however, that financial repercussions are not severe if oil is not delivered at the pace expected, as the IOC bears the responsibility for such failure to fulfil the contract. However, the problem of contractual length is of greater significance here as significant investments that have been made, including building of facilities, will be lost when the contract runs out, therefore making the maximal lengthening of such contracts a top negotiating priority when aiming to maximise profits. Nonetheless, this issue illustrates the divergence between Iranian oil contracts and the generic International model due to particular concerns of dealing in oil.

7.3 Administrative and Fiscal Provisions of the Model Contracts

The provisions of the contractual models compared in this section regarding their administrative and fiscal provisions are detailed below, paying special regard to those surrounding foreign presence, development and investment in Iran. Also considered is the impact of the different legal technicalities when interpreting the buy-back model and how this has led to occasional disagreements with foreign contractors.

7.3.1 Administrative and Fiscal Issues Related to the Foreign Presence

An extensive administrative and technical operation such as the ones required to develop oil fields also involve a significant number of administrative and fiscal issues.⁴³⁶ As the costs and financial transactions involved in oil production for a foreign participant are significant, the issues of whether or not such activities will be taxed can make or break a contract and significantly alter the attractiveness of Iranian buy-back offers.

A further issue of great importance to both mundane operations in relation to buy-back and where legal disagreements are concerned is the applicable law. Different jurisdictions will have different rules for interpreting terms of the contract, different remedial systems and different rules on validity of contract. For example, the English contractual system is more inclined to allow parties to terminate their contracts for even minor breaches if those terms are identified as conditions of the contract interpreted from the point at which the contract was made. On the other hand the CISG is more reluctant to allow termination, only granting the remedy when the breach causes substantial detriment to the aggrieved party, while Iranian law can be heavily influenced by additional factors specific to the Islamic basis of its government, for instance a prohibition on interest.

Under Article 18 of the international model, the agreement, where any legal issue is concerned, the guiding jurisdiction is the one specified within the contract.

The Iranian version of the model clearly gives the issue of jurisdiction the attention it deserves by specifying the set of laws by which the contract is to be governed, leaving little to exploitative interpretation. In order to ensure that the contractor's activities fall within the jurisdiction of

⁴³⁶ Both in the form of tax payable on the foreign party's activities as well as issues of company registration.

domestic judicial and official authorities, Iranian model agreement in, Article 7.2, prescribes that a branch be registered in Iran in order to ensure such legal coverage.

Article 7.2 states that:

Contractor shall register a branch office in Iran for the purpose of following and complying with local laws.

In addition to establishing judicial jurisdiction through company registration, the subsequent Article then unequivocally states the legal system by which the contract should be handled.⁴³⁷ Consequently, Article 31 establishes the governing law of the contract. This removes any problems that may arise from issues of jurisdiction.

Article 31 states that:

Contract governed, interpreted by the laws of Iran.

Rules on levies, charges, fees and taxes are enumerated in Article 8, ensuring the legal certainty required for a deployment of foreign workers and capital in a country with a different fiscal system. Exceeding clarity in these terms is required as, historically, the issue of whether or not companies be taxed while developing oil in Iran led to a number of serious disagreements with outside participants.

Article 8.1 states that:

Any Iranian corporate income tax, Social Security Charges, or other levies imposed are payable by Contractor and an amount representing such charge shall be compensated by the NIOC to Contractor.

⁴³⁷ This is a vital point when considering the extensive amount of arbitration and disputes arising out of Iran's pre-buy-back oil contracts.

Compensating the contractor for losses incurred due to local taxation and levies ensures that the contractor is in compliance with local law, which is necessary per Article 7, but has a tax incentive for investing in Iran. The above mechanism is a legal way of a foreign investor avoiding certain taxes. While this cost is absorbed by NIOC they are owned by the government and so in effect the Iranian government are waiving various taxes and levies in return for investment. A further motive for such a circuitous arrangement may be to prevent public dissatisfaction with the taxes being directly waived; due to this arrangement, the government may state that taxes are indeed payable by the foreign company and their eventual compensation will be more difficult to notice. Nonetheless, limits are placed on the compensation, in Article 8.2, to ensure that no unjust enrichment takes place due to tax returns on activities taken outside the country, which therefore did not benefit Iran commercially.

Article 8.2 states that:

Contractor shall not be entitled to recover as Petroleum Costs,⁴³⁸ and taxes charges, fees and levies upon its income levied outside of Iran nor any taxes, charges, fees and taxes of any nature that are paid directly by NIOC.

As not all the needed equipment may be bought in Iran,⁴³⁹ the Contract recognises that the foreign contractor should not be fiscally penalised for importing it, especially as it may be needed for ensuring high output of the fields, which is beneficial to the NIOC. Moreover, a possibility exists that such equipment will be either abandoned upon the finalisation of the production or would have to be left behind due to the Model Contract's provisions; therefore making the encouragement of imports a logical course of action, as per Article 25.

⁴³⁸ Article 8.2 sets a limit on the size of compensation by barring reimbursement for anything that is not "petroleum costs", as per Articles 22. 1-4. It remains to be seen whether this element of the Model Contract may be overwritten by future amendments of the Majlis.

⁴³⁹ Although this is encouraged by the business preference provisions elsewhere in the Contract.

Article 25 governs the procedure for the importing and exporting of equipment for the purposes of the development of the oil field. It is consistent with the principle that the contractor bear the cost of development and that Iran should reap the benefits of improved infrastructure. However, in order to ensure that the contractor not bear undue burden NIOC will pay for any custom duties on the import. This ensures that the import of goods is not much more expensive than the Iranian alternative had it existed.

Article 25.1 states that:

Materials and equipment that are not available in Iran shall be imported in the name of NIOC
Any customs duties shall be paid by the Contractor and shall be reimbursed as non-capital costs.

7.3.2 Rights and Obligations in Relation to Land and Resources

Due to the scale of oil development operations, significant resources and local cooperation, as well as interaction with the land being used are required in order to assure the operation’s success.

Such rights that are exercisable by the NIOC are written in Article 5 of the contract. The section ensures that NIOC is not limited in what it can do with the land while the contract is in force.⁴⁴⁰
The section also establishes that the NIOC has the right to insure materials and equipment under the contract.

The terms in Article 5 are as follows:

NIOC shall exercise all necessary control and supervision and has all rights to utilize the Contract Area for purposes not related to this Contract, except that such usage shall not prevent or hinder the carrying out of the Development Operations within the Field. Regarding insurance

⁴⁴⁰ If for example a gold mine was found in an area that was being developed the NIOC would not want to be restricted in its exploitation of the find because of a development contract where such exploitation would not hinder the development operations.

NIOC has the option to provide any legally required insurance coverage of materials and equipment, pursuant to Clause 12.

In an attempt to curtail the extensive risks faced by the foreign participant, Article 6 allows requests for help to be made of the NIOC and obligates it to fulfil them. Nonetheless, special attention must be paid to the word ‘reasonable’ in the definition of such assistance, which can be quite widely interpreted in order to deny assistance if it is seen as inconvenient. As the process of arbitration regarding disagreements over the interpretation of such terms as ‘reasonable’ is difficult and weighed against the foreign participant, a possibility exists that this Article may only be window-dressing in most instances where helping would be costly. The section specifically enunciates NIOC’s obligations to the foreign investor under the contract should they require additional resources in the form of land and water.

Article 6.1 states that:

Land and water reasonably required by Contractor for the purpose of Development Operations shall be acquired by the NIOC and put at the disposal of Contractor. The purchase prices shall be either paid by NIOC or included in the Petroleum Costs if paid by Contractor.

In order to shift some of the operational responsibility from the foreign party, Article 16 grants the right to operate all facilities immediately post-start-up to the NIOC.

Article 16.1 states that:

NIOC shall be the operator for all facilities, immediately after commissioning and start-up.

7.3.3 Determination of Land and Fixtures' Ownership

As oil projects require not only the drilling machinery to succeed, but also a variety of other structures and fixtures,⁴⁴¹ the issue of what happens to the structures built by the foreign participant after the contract's expiration may have significant financial implications.

Article 11 deals with the ownership of assets in the form of fixtures and installations imported or built by the contractor. By retaining ownership of all non-temporary equipment NIOC ensures that Iran gains the benefits of the improved infrastructure created by the contractor.

Article 11.2 states that:

All lands and assets acquired by the Contractor shall be the property of NIOC, except for machinery and equipment imported on a temporary basis pursuant to provisions of clause 25 hereof.

7.3.4 Administrative Authorities and Operations

In order to prevent conflicts and disagreements, as well as to minimise bureaucratic wrangling and related expenditure,⁴⁴² an overseeing body was created so as to maximise cooperation between the domestic and the foreign participants, as per Article 17, which governs the composition of the Joint Management Committee who will oversee the development.

Article 17.1 states that:

The Joint Management Committee⁴⁴³ of five representatives from each party. NIOC shall function as the JMC Chairman until the end of the first year, and thereafter JMC chairmanship shall alternate between members annually.

⁴⁴¹ Such as administrative buildings, worker barracks, utility buildings and security structures.

⁴⁴² As such expenditure and time waste is likely to be higher if officials from both sides must travel to a single location for resolution of unexpectedly arising issues.

⁴⁴³ Also known as JMC

The above term grants some additional bargaining power and control to the NIOC in the first year. Given that the chairmanship will alternate between parties and that it is in the interest of both parties to maintain an atmosphere of mutual cooperation this clause is not onerous to the contractor.

In addition to the regulation of administration, provisions are included in both the International and the Iranian agreements to determine whether the role of one party can be passed down to an alternative commercial entity. Such rules are necessary as excessive assignment may result in confusion and administrative delays.

The assignment clause is one of the more important clauses as it allows the buyer to assign his contractual rights or commitments either wholly or partially to a third party, as outlined in the International articles below.

Article (A) 6.1 states that the seller shall not have the right to assign his obligations and rights without agreement from the buyer, which must take the form of a clear acquiescence in writing.⁴⁴⁴ However, such consent shall not be unreasonably withheld.

Therefore the seller may assign his contractual obligations to another party but he must first notify the buyer of his intentions and the buyer will only be able to withhold his permission where the seller's act would be unreasonable. That presumably means where the assignment would adversely affect the other party's interests. The party is not restricted to whom he may assign his contract to should he choose to do so.

⁴⁴⁴ Replace "Y" with the name of the appropriate Government body in Y land, when applicable.

Following Article 6.2, if assignment occurs to a different legal entity,⁴⁴⁵ (hereinafter “the assignee”):

(A) All commitments and rights of the original signatory will be eliminated at time of signing, with these legal burdens and rights then transferred to the assignee, assuming that consent was correctly acquired and noted (B) the party that executed the assignment will maintain joint and severable responsibility, along with the party to whom the rights were assigned, for the fulfilment of the relevant duties described in the agreement.

Article 6.4 elucidates that if assignment occurs without notice being provided to the other contractual signatory, within a period considered acceptable, then liability for damages will arise.

The section effectively states that the seller is free to do with his contract whatever he wishes so long as it does not adversely prejudice the buyer. He must first notify the buyer of his intentions and failure to do so may result in damages being awarded against him. The seller is free to retain or sell any or all of his contractual obligations as he sees fit. However, the assignor will remain liable in circumstances where the assignee fails to deliver what the assignor promised under the contract. For that reason the assignor is likely to take steps to ensure that he can indemnify himself against the assignee should he breach. The outlining of the procedure of passing down obligations and the limitations on doing so is extensive in the case of the International scheme. In contrast, only sparse attention is given to this subject in the Iranian scheme, with the effect of leaving fewer protections and opportunities for assignment to the buyer.

⁴⁴⁵ Assignor is the buyer or the seller who has transferred their rights and obligations under the Buy-Back contract to a third party (the Assignee).

Article 27.1 states that:

Any assignment by Contractor shall require the prior written consent of NIOC, which shall be granted or refused within thirty days of receipt by NIOC of notice that such an arrangement is intended.

It is of especial note that the NIOC has full discretion to either reject or accept the assignment without any requirement of the decision being 'reasonable', as is the case with the International version. This clearly shifts the balance in favour of the NIOC and such a shift does not appear equitable, as no constraints are placed on the exercise of the power and it is doubtful that even utilising arbitration could resolve the issue as any rejection, made for whatever reason, would be within the framework of the contract.

7.4 Regulation of Buy-Back Operations

The regulations surrounding insurance, re-sale negotiations and employment and business preferment provisions in the buy-back models compared make a great deal of difference to the overall contracts and the relationship between the buyer and seller. In the Iranian framework, emphasis is on domestic solutions provided under the wing of the NIOC rather than outside parties, and the impact that this has is discussed here.

7.4.1 Regulation of Insurance

As the value of the machinery and facilities used in oil operations is very high, significant insurance protections are required so as to avoid further adding the possibility of uncompensated accidental or other damage to the bundle of risks that the IOC must contend with. As insurance premiums would be a significant sum, the Model Contract prescribes that such insurance must

indeed be bought and this must be done from an Iranian operator, for the maximum benefit to the economy.

Regarding insurance, Article 12 places a general obligation on the contractor to maintain insurance coverage or, if it is easier, for the NIOC to provide insurance coverage at the contractor's expense.

Article 12.1 states that:

Contractor shall maintain insurance coverage in amounts required and NIOC may exercise the option to provide, at the contractor cost, such coverage at rates not greater than market rates elsewhere.⁴⁴⁶

Due to restrictions which only permit insurance contracts signed with Iranian insurers this may be a little onerous on the contractor who might otherwise have been able to make a better deal. It does however match the recurring theme of the buy-back contract which is to benefit the Iranian economy. By limiting insurers to ones based in Iran, Iranian insurance companies are given greater access to major oil contracts.

7.4.2 Employment and Business Preference Provisions

The importance of employment regulation in the Contract cannot be overestimated. A key reason why foreign participation in Iranian oil is required at this time is the insufficiency of domestic expertise in the area,⁴⁴⁷ namely the technological superiority of Western companies. Through mandating certain employment ratios and preferences, the NIOC can ensure that a transfer of technical expertise and know-how can occur through 'on the job' training of Iranians together

⁴⁴⁶ It is noteworthy that insurance contracts may only be signed with Iranian insurers.

⁴⁴⁷ Such employment-preference provisions are indeed one of the hallmarks of the earliest Iranian oil contracts where a similar purpose was pursued, to a relatively successful extent as some experts believe that Iran has sufficient trained personnel to manage its oil production independently.

with foreign experts. This scheme also suggests the possibility of Iran's eventual independent operations once sufficient equipment and expertise becomes available.

Article 13 creates a preference for the employment of Iranian nationals by foreign companies in the course of the buy-back contract. Again this benefits the Iranian economy by ensuring that Iranian workers are employed wherever possible. This reduces unemployment and generates income.

Article 13.1 states that:

Contractor shall give priority to Iranian citizens in employment, or personnel to carry out the Development Operations, limiting the employment of foreign personnel to only positions where qualified Iranian citizens are not available.

In regards to the requirements set out in the above Article, it can be added that the foreign company is obligated to prove that a non-Iranian employee has skills that are not available on the domestic employment market. Additionally, it is mandatory for training to be provided to Iranians with the purpose of eventually substituting the foreign worker. A further requirement is that the foreign employer must, on a mandatory basis, donate a sum of money that is a certain percentage of the foreign worker's pay.⁴⁴⁸ With regard to the expatriate employees' legal status, they must acquire a work permit from the Department for Employment of Expatriates at the Ministry of Labour and Social Affairs (MLSA), as well as a simultaneously applied-for, one-year duration, renewable residence permit. If the company wishes to terminate their employment, they must navigate a complicated process, including a permission to terminate from the Labour Boards, which rarely favours the employer in their judgements.⁴⁴⁹

⁴⁴⁸ Set at a minimum of IR 560.00 (about US\$70), as of 2001.

⁴⁴⁹ Therefore this rather unbalanced dismissal procedure provides a deterrent to firing of local employees.

In addition to the provisions above, aimed at maximising both the income from the foreign companies for domestic experts and ensuring an exchange of expertise, Article 24 ensures such an exchange on a larger scale by encouraging business involvement with domestic companies, particularly in equipment purchases.

Article 24 states that:

Contractor shall use the service of Iranian firms for the provisions of maximum utilization of Iranian content of the project with due regard to the laws of Iran.

This section expands on a recurring principle in the contract that foreign investors should make use of local resources wherever possible. It highlights one of the major purposes of Iran opening up its oil market to foreign investors, which is the building of infrastructure within Iran. Forcing investors to utilise Iranian workers improves the Iranian economy by increasing employment, creating skilled workers and making use of equipment made in Iran.

7.4.3 Limitations on Re-Sale Destinations

An additional means of profiting from a buy-back transaction is the resale of products to a third party. For commercial or political reasons, one of the parties may decide to limit the destination of such transactions and the International contract provides such an option in Article 7. This clause will affect the value of the contract. If the seller wishes to resell the goods, which in the case of a buy-back transaction for oil he will certainly want to be able to do if he wishes to make a profit, he may be restricted by Article 7. Obviously the wider the seller's discretion on whom he may sell to, the greater the money-making potential in the contract and thus the more valuable it will be.

Article 7.1 states that the seller or any other legally empowered party acquires the ability to re-sell the output within the area prescribed by clause 7.2 below:

(A) 7.2 The area will encompass all nations.

(B) 7.2 The area will encompass all nations specified within the appendix for the particular categories of product. .

(C). 7.2 The territory shall include the seller-land.⁴⁵⁰

Per Article 7.3, the output cannot be re-sold anywhere but inside the prescribed territory without separate agreement from the buyer.⁴⁵¹

Per Article 7.4, the signatories will abide by the commitments above without seeking to actively market the output anywhere but within the permitted areas.⁴⁵²

With the obvious exception of option (A) in Article 7.2, the seller will not be allowed to place products in the market outside of the agreed territory unless he gets written consent from the buyer. This clause gives the buyer the potential for great control over the seller's money making potential. However, the negotiation process will mean that should the buyer try to overly restrict the seller's business, the seller will be willing to pay less money for the contract.

In contrast to the elaborate rules on the issue in the International model, its Iranian version takes an entirely liberal stance on the issue by not limiting the target of re-sale, therefore providing the widest possible opportunities for making a profit from the oil sale, outside the original contract. Considering the generally restrictive nature of Iranian buy-back agreements, this concession may add a degree of attractiveness to involvement in Iran.

⁴⁵⁰ This term denotes X-party's place of residence. In the case of a company, it is the place of registration.

⁴⁵¹ Not relevant if choice A is selected

⁴⁵² To be inserted if X land or any of the countries within in Appendix are European Economic Community (EEC) members.

7.5 Remuneration and Compensation Provisions

Naturally, no other part of a Contract can be more important than the one prescribing the distribution of costs and profits.⁴⁵³ A clear and precise set of provisions in this area is of special importance for the parties involved for the obvious reason that it prevents disputes arising over what is owed but also because in many jurisdictions a contract will only be valid if it has a price attached to it. Of course, the International scheme must take a much wider and more general view on these issues as such a scheme may be applicable to both service and product transactions, and therefore the payment methods and types may alter. The most relevant International provisions in this respect are provided below.

Article 4 establishes the details of the price at which the seller shall purchase products from the buyer. Thus Article 4 describes the overall value of the agreement.

Per Article 4.1, in the course of the agreement's duration, the seller will buy the buyer's output for either a price that has been previously agreed upon or for a value of not less than a given percent of the total, as per the agreement. The price of the unfixed value contract will not be less than a given percent of the overall technical and equipment costs, as per the original agreement.⁴⁵⁴

Following Article 4.2, the value of the various sub-agreements aimed at resolving operational tasks, will be the cost of the relevant term of delivery⁴⁵⁵ of the respective Implementing contract.

Article 5 establishes further rules on how the prices in Article 4 are to be determined. This article is worded in such a way that if there is conflict between Articles 4 and 5, Article 5 will win. It

⁴⁵³ This is especially true in a Buy-Back contract as the compensation and payment system is not as straightforward as in most other commercial transactions.

⁴⁵⁴ Meaning the sum and the type of currency.

⁴⁵⁵ e.g. F.O.B. or C.I.F. etc

essentially enshrines a doctrine of fair dealing into the contract which prevents one of the parties unfairly taking advantage of the other due to circumstances which may include a grossly disproportionate level of bargaining power.

According to (A) Article 5.1 the prices of the output relevant to the agreement will be:

- (1) The value of the output will be evaluated at the end of the sub-contracts for the output's production, taking into account the commercial context in the relevant area of commerce at the time when the transaction occurs.⁴⁵⁶
- (2) The price of the output on the general market, under competitive terms of delivery and payment.
- (3) The cost of similar items, depending on the extent of similarity dictated by the level of quality and other attributes, within the relevant area.
- (4) The agreed commodity exchange rate when the sub-contract is finished.

As per Article (B) 5.1, the value of the output will be negotiated in each particular case by the sub-contract's seller and buyer.

The alternative Article 5, as has been noted, incorporates an all but explicit duty on parties to deal fairly with each other with regard to the pricing of the contract. This duty to deal fairly owes much to the United Nations Convention on Contracts for the International Sale of Goods (CISG). The alternative Article 5.1 is largely based on Article 55 CISG which follows a general principle of good faith to be found throughout the convention and explicitly noted in Article 7(1) CISG.

⁴⁵⁶ This alternative is based on Article 55 of the United Nations Convention on Contracts for the International Sale of Goods, 1980.

Given that the CISG has been adopted by the majority of industrialised nations⁴⁵⁷ it is unsurprising that its principles have been adopted in international standard form buy-back contracts.

As often occurs in an international sale payment under a buy-back contract is cash against documents. This being the case, the accuracy of the documents will be of utmost importance in the majority of jurisdictions. Common law and many civil law jurisdictions are strict in their requirement for documents to be accurate and will often allow termination for even minor breach of documentary obligations.

As a result of an overview of the terms suggested by the International scheme, the clear theme of fair and balanced dealing emerges through the supremacy of Article 5 with its assorted commercial safeguards. Moreover, the technical details of the transactions are given with remarkable precision for such a generic, international scheme.

In contrast to the standard International agreement, some significant changes are present in the Iranian scheme, mostly as the result of the unique subject matter of oil, which involves significantly different procedures from the sale of products as envisioned in the International version.

Among the most important Iranian model provisions is Article 18, which governs the Master Development Plan and Budget. The difficulty of predicting the Master Plan's expenses is one of the most serious IOC grievances as it remains liable for any inaccurate estimates. For obvious reasons the terms of this clause are not set in stone as the budget will vary from field to field dependent on various factors including the bargaining power of each party. The Master Development Plan governs the development of each individual oil field.

⁴⁵⁷ Notably the United kingdom have not ratified this convention.

Article 18.1 states that:

Master Development Plan, including Work Programs and Budgets for the Development attached as Appendix [...]. Capital Costs shall be equal to or less than (To be Negotiated) for the field to carry out the Development Operation, expended over (To Be Negotiated) years from effective date in the manner set out in more detail in Appendix “the seller”. First / or additional production in the field is projected to occur within (To Be Negotiated) months after the Effective Date.

The amount in Sub-Clause 18.1 shall be the contracts ceiling, which shall not be increased.

Although such a Plan is not explicitly mentioned in the International scheme, it nonetheless bears many similarities to the relevant articles mentioned there; for instance minimum expenses are prescribed, as well a time frame. The absence of a specific reference to such a plan in the International scheme is that this concept is specific to a service contract where significant engineering and development involvement is required, which does not appear to be the focus of the International version.

Of equal significance is Article 22, which governs the cost recovery and remuneration fee. This is obviously of immense importance to the contractor as he makes his profit via his remuneration, while costs can undercut or eliminate this profit entirely. Again the level of remuneration is not fixed as what is good remuneration for one contract will not necessarily be good for another.

Article 22.1 states that:

Contractor shall recover Petroleum cost, together with bank charges from the month the expenditure occurred at a rate equal to LIBOR plus/minus (To Be Negotiated) percent.

Article 22.3 states that:

Remuneration Fee – In addition to the Capital Costs, Non-Capital Costs, Bank Charges thereon and Operating Costs, Contractor shall be entitled to a remuneration fee of (To Be Negotiated) US Dollars to be paid commencing the first month following the date of first/additional production from the field as follows: (To Be Negotiated)

In case of any changes required and approved by JMC in order to achieve the objectives of the Development Operations set forth in the original Master Development plan Contractor shall only be entitled to recover the additional related capital costs, resulting from all such approved changes up to the ceiling amount pursuant to clause 18.1 and subject to clause 18.3. In such case the Remuneration Fee shall remain fixed and unchanged.

As can be seen from the above, one problem with the reimbursement procedure is its dependence on negotiation, as the procedure itself is not clearly defined in the Model Contract. Considering the bureaucratic nature of the NIOC, however, such negotiation rather than clearly stated procedure and values, may lead to a lack of legal certainty and confidence, especially as negotiations may lead to lost production and administrative costs.⁴⁵⁸

On a more procedural note, Article 22.4 outlines the specific process involved in paying the compensation for the production project in oil. Similarly to one of the temporal Articles, 22.4 notes that insufficient compensation will only be rectified if the time limit stated there has not yet expired, therefore not remedying the deficiency of the temporal Articles.

Article 22.4 governs the arrangements for payment in oil:

⁴⁵⁸ For instance, if delays occur, the foreign entity would ordinarily receive an interest payment on the sum owed. Such a mechanism, however, would be treacherous under Islamic law, which prohibits payment of interest.

Petroleum costs and the remuneration fee shall be paid to the Contractor. Oil/gas out of (To Be Negotiated) percent of the product produced from the field and delivered to Contractor pursuant to the crude oil/gas sales agreement.

In the event that the petroleum Cost and Remuneration Fee are not fully paid during the Amortization Period, Contractor shall be entitled to receive Crude oil/Gas produced from the field as a result of Development Operation carried out by Contractor, pursuant to the Long Term Sales Agreement, until such Petroleum Costs and Remuneration fees are recovered, or the terms expires pursuant to clause 3.3.

Further procedural issues arising out of the long term crude sales agreement are dealt with in Appendix "C". Especially of note is the provision regarding quantity, as it depends on accurate estimates of the oil to be lifted being made on a quarterly basis. This is a concern for the IOC as such forecasts are often inaccurate due to field depletion, leading to distorted projections and subsequent losses.

Regarding quantity:

JMC under the Service Contract shall advise Seller (NIOC) and Buyer (Contractor) of the recoverable costs to be due to Buyer and the Service Contract (Service Contract Fees) during the next Quarter. Based upon the forecasted Service Contract Fees due to Buyer, Buyer shall furnish to Seller a statement of the volume of Crude Oil to be lifted in the lifting Quarter in order to compensate Buyer for the forecasted Service Contract Fees.

The specificity of the description of payment means and terms, as well as the allocation of the expenses involved, is consistent with the International contract's similar level of detail. Although some elements of the domestic contract, for instance the provision describing the contingency of oil value dips resulting in insufficient compensation, do not have an equivalent in the

International contract, they appear to be nonetheless in the spirit of giving significant discretion to the parties in deciding such contractual nuances. Therefore the oil-specific arrangements made in the Iranian contract appear to strike a fair balance between following the general framework of the International agreement scheme and adjusting it to fit the circumstances of Iranian oil specifically.

7.6 Dispute Settlement and Arbitration

Although arbitration provisions are not likely to be relied on as often as the more mundane provisions, their presence is nonetheless vital for the stability of the commercial relationship and for ensuring that minor disputes do not escalate to full fledged conflict.⁴⁵⁹ However, even if the dispute is serious and threatens to undermine the fairness of the relationship, arbitration plays a vital role in reaching a consensus between the conflicting parties rather than resorting to annulment, nationalisation or similar dramatic and disruptive measures that have been used in cases of disputes in Iran's oil history. By avoiding the courts and settling the disagreement in an environment of compromise and cooperation rather than in an adversarial courtroom is likely to ensure decreased friction between parties.

The International model broadly outlines the principles to be used in arbitration, especially on the specific procedures involved and in relation to the finality of decisions made, as well as who is to make them. The Articles from the International model below illustrate this general attitude

Article 19 deals with the issue of how parties to the contract are to settle any disputes that may arise. The purpose of this section is to ensure that what may be a relatively minor dispute does not escalate into something that would threaten the buy-back contract.

⁴⁵⁹ For instance the dispute regarding the definition of 'ton' between Britain and Iran in relation to the 1933 concession; an issue solvable without political crisis and unrest through mediation and arbitration.

Per article 19.1, any disagreements related to the agreement, which informal negotiation cannot resolve, will be open to arbitration , by an agreed number of arbitrators under the rules agreed upon by the parties to the contract.

Following Article 19.2, their determination will not be open to any legal appeal and will have to be paid.

And under Article 19.4 the location of arbitration will be decided in this section by the contracting parties.

An analysis of the above International articles shows that an emphasis is placed on the will of the contractual parties rather than the imposition of any particular arrangement by a higher authority or by the contract itself. This is evident as the location, the means of dispute resolution, the identity and number of arbitrators are both discretionary. Despite allowing these decisions to be made by participants, it is nonetheless outlines a solid framework around which arbitration proceedings can be built while also mandating that awards and decisions are final; therefore avoiding unnecessary wrangling on issues of finality after arbitration finishes.

As the framework provided by the International agreement is so broad in this respect, therefore making it unlikely that the Iranian model contract will diverge from such general guidelines. Nonetheless, its comparable Articles are examined below.

Article 32 deals with dispute settlement and arbitration:

Any dispute, controversy or claim arising out of or relating to this contract or the breach, termination or invalidity thereof, shall be finally settled by arbitration before three arbitrators. Any award of the arbitrators shall be final and binding on the parties. Either party may seek execution of the award in any court having jurisdiction over the party against whom execution is sought.

The arbitration procedure ensures that if a dispute arises there will be an attempt to resolve it in a fair and balanced manner that does not unduly favour any one party. Clearly, the Article conforms to the general power to decide on the structure of this process in the International model. However, this Article is not of decisive importance as it only describes the procedure in a general way and the actual fairness and objectivity of it is more accurately determined by the identities of the arbitrators and the precise procedures of such conflict resolution as covered in Appendix D.

The first relevant provision of the Appendix D governs the location of the meeting, which is perhaps of procedural rather than substantive importance, although it may convey an advantage to one of the sides due to the relative superiority of influence on one's home territory.⁴⁶⁰ The International contract appears to find this detail of importance as a separate provision is provided whereby the decision in this regard is assigned to the participants, as is the case in its implementation in Iran.

Section 3 of Appendix D states that the location will be negotiated by the signatories involved in the disagreement. In the event that an arbitration site cannot be agreed upon prior to the appointment of a third arbitrator, then the arbitral tribunal shall, as its first act, convene in Tehran, Iran, to decide upon the site of arbitration.

Section 4 outlines the crucial issue of the identity of the arbitrators, as objectivity is difficult to find in those belonging to the same country as the disputed parties. The provision's emphasis on the first two appointees deciding on a third, however, may result in significant confusion and

⁴⁶⁰ It is noteworthy that in case of a dispute regarding the location, Iran is the default fallback option, suggesting a subtle advantage for the NIOC.

delays if agreement cannot be reached, as is likely to be the case since the first two arbitrators are likely to be partisan, as they are permitted to be of the same country as the parties.

Section 4 states that:

Each signatory will have the power of appointment for a single individual, with the first two appointees then finding a third member to chair the group, who mustn't originate in either of the signatories' states.

The last pertinent section refers to the requirements for initiating arbitration in the first place, and is perhaps the most controversial arbitration provision. As an extensive 'approval of authorities concerned' procedure is required for a foreign participant to initiate arbitration,⁴⁶¹ it is probable that where sensitive financial or political issues are involved, the progress of the arbitration claim will be stalled or slowed by these authorities, acting to protect Iran's interests. On the other hand, if it is the domestic party submitting such a request, it is probable that approval will be given almost immediately for the same reasons. Consequently, a provision granting control over the superficially objective arbitration procedure to a deeply biased authority is questionable at best.⁴⁶² This controversial procedure is set out in Section 11.

A possible weakness of the International contract is evident from this precipitous Article, as the general model agreement does not avert the insertion of such biased clauses into the agreement, as they still fall within Article 19, being procedural decisions regarding the Arbitration system. Perhaps a more concrete and firm prohibition on excessive restrictions to arbitration access would have been more appropriate to prevent unequal power relationships within the contractual agreement.

⁴⁶¹ Namely the Majles as well as NIOC committee approval, which clearly either have close ties to the government or are the government, one of the parties to the arbitration.

⁴⁶² Even if conscious bias does not occur, certain procedural issues may arise from including the Majles in the arbitration approval process, for instance getting such approval while the Parliament is on vacation or when there is no quorum.

Section 11 states that:

Referral of matters on dispute to arbitration by either party, shall if necessary to subject to the obtaining of the approvals of the appropriate authorities of the parties concerned.

Appendix D lays out a set of rules that should produce a panel of arbitrators that will not unduly favour either party. Whether or not this process will go smoothly or at all, rather than be mired in procedural disputes regarding appointment and permission to proceed with arbitration, is dependent on the individual parties' willingness to cooperate.

Generally, however, the Iranian model is in broad conformity with the International agreement scheme, due to its breadth and lack of protections; in letter if not in spirit.

7.6.1 Circumstances and Consequences of Termination

Although the termination of a contract is only a measure of last-resort, following the failure of other options such as negotiation and preliminary arbitration, it is nonetheless important that provisions are included to provide legal certainty in the contingency that termination does become necessary. The International scheme is far superior to the domestic implementation in the buy-back contract being examined, as it includes detailed procedures for dealing with the termination of a buy-back contract whereas no such provisions are included in the Iranian equivalent. The detailed International provisions are the first to be examined as a model of the level of detail required.

As per Article 16.1, if the basic agreement is terminated prior to any change of hands in the technological and logistics material, the agreement will be annulled.

Per Article 16.2, within this agreement, the seller’s duties will:

- (A) Be considered as finished even in cases where one of the sub-contracts is subsequently terminated, as long as such an event occurs not as the result of the seller’s actions.

- (B) Will not be considered as satisfactorily concluded if any sub-contract is subsequently terminated, no matter the reasons. In such a contingency, the seller will have the obligation of concluding additional sub-contracts which would equal the value of the original agreements that have been terminated

Article 16 explains what will occur with regard to the seller’s other obligations should the buy-back contract or part thereof be terminated. This article ensures that both parties are aware of their positions should the contract be terminated by either party. The position appears to be that when the contract is severed dealings between the parties should be brought to an end as swiftly and with as little conflict as possible.

The Iranian contract being examined in the capacity of a model, however, does not contain termination-specific provisions and the outcome will be resolved through arbitration, with the extent of compensation or loss of assets depending on the stage at which the buy-back project is located. The lack of such provisions may lead to a great deal of confusion, legal action and lack of trust for future business relationships in the case that termination is sought by one of the parties due to changed circumstances. It is also worthy of note that not all such attempts at termination would be inequitable or designed to be commercially exploitable; it may indeed be a case of an unexpected war or natural disaster that compels termination. Consequently, it appears to be a significant deficiency of the Iranian version that no contingency scenarios are provided for cases where termination is sought, while the International version does provide for compensation in such cases.

7.6.2 Discharge of Buy-Back for Breach

One means of inspiring confidence in potential buy-back participants is ensuring that

Article 14 deals with each party's liability under the contract. Liability under the contract is generally strict liability with only a minor fault based element. The breaching party will be liable for the damages specified in earlier articles of the contract. Because the levels of damages tend to be agreed sums this is likely to eliminate the problems that can arise from having a court calculate a damages award.

Following Article 14.1, if the seller's obligations are not entirely completed by the time agreed upon in Article 10.5, the seller will be obliged to pay damages to the buyer based on the cost of products that have not yet been bought, as per Article 4.1

Continuing from 14.1, Article 14.2 states that subject to the previous provision, the seller will not have to pay any costs if the cause of the problem stems from the inability of the seller to provide the output of the same attributes as have been agreed upon.

Per Article 14.3, if the cause of the disagreement falls within the scope of 14.2, then remittance to the seller as well as damages, accounting for the earnings from future transactions, must be provided.

Following Article 14.4, a bank guarantee shall be provided by the seller to the buyer for an agreed amount.

Article 14.5 is essentially the same as Article 14.4 but it deals with the buyer issuing the seller with a bank guarantee. The names the seller and the buyer are therefore swapped.

Article 14.6 states that the payment made in response to a claim of compensation will conclusively end any further claims on the subject matter of the same breach.

Under Article 14 where the seller or the buyer has failed to perform the issue of fault does not arise. Under the contract it does not appear to matter whether either party is responsible for the breach or whether it was out of their hands. Liability is therefore strict. The one exception to this rule is where the seller of the goods, usually the buyer, has breached and this has caused the seller to fail to meet his buy-back commitments. In those circumstances if the buyer takes action against the seller, the seller may take action against the buyer. In the above case the seller's breach may not necessarily have been his fault, nevertheless he has breached and that has caused the seller's failure and so it would not be equitable to hold the seller accountable.

The issue of fault does arise under Article 15 which deals with relief. Article 15 has its basis in Articles 79 and 80 of the CISG. Case law under the convention may therefore be relevant when discussing this issue and may be persuasive to the court should a dispute arise to which Article 15 is relevant. The article deals with the issue of frustration of contract.

Article 15.1 states that if a contractual breach occurs the cause of which was an event uncontrollable by the breaching signatory, and not one that could have been anticipated and accounted for during the formation of the agreement, then no liability will arise.

Following on from Article 15.1, Article 15.2 states that the clause above will allow protection from liability only for as long as the uncontrollable barrier persists. If the barrier to performance is maintained for a period longer than that prescribed in the agreement, either signatory can provide notice of termination without any liability arising.

Per Article 15.3, the signatory must define the obstacle and its influence on performance within acceptable time limits, otherwise contractual costs may be incurred by the breaching signatory.

Per Article 15.4 a signatory cannot place reliance on the other signatory's lack of performance if the inability to do so results from the former signatory's actions.⁴⁶³

Liability under the contract is still strict but for where an event was unforeseen by the breaching party when the contract was concluded and could not be reasonably foreseen by him and that event causes the breach. Where an event was foreseeable the risk will pass under the contract and fault will be irrelevant. The frustrating event will not immediately bring the contract to an end. Instead, subject to valid notice being given, it will suspend the obligations of the parties until the frustrating event has ended. If the impediment lasts longer than a period of months agreed upon by the parties then either of them will be allowed to terminate the contract.

7.7 Miscellaneous Requirements for the Conformity of Output under the Buy-Back

As buy-back schemes may be used in relation to not only oil extraction but a variety of other production processes and subject matter, an extensive section in the International model deals with the prescribed quality, quantity and delivery times of the product involved.

Article 2 makes the first step in identifying specific terms to which the products must conform under the contract. It also identifies the products as those items agreed upon by the parties.

Under Article 2.2, the party playing the role of the seller thereby commits to the availability of the prescribed output according to the timetable set out in Article 10.

⁴⁶³ This Article is based on Articles 79 and 80 of the United Nations Convention on Contracts for the International Sale of Goods 1980

Article 2.2 ensures that the time of delivery is a term of the contract although it does not explicitly make time of the essence.

Terms regarding the conformity of products are established in Article 3. It makes the description, amount and attributes of the output, terms of the contract, breach of which will result in the aggrieved party having the right to seek a remedy under Article 14 subject to the provisions in Article 11 and 15.

Per Article 3.1, the output will have the pre-agreed attributes, be of the agreed amount and also correspond to the sub-contracts created for their purchase, known as “implementing contracts”⁴⁶⁴ and agreed to within the boundaries of the original agreement , with the buyer (hereinafter “the implementing the buyer”⁴⁶⁵).

These are fairly standard terms of contracts, often implied by legislation in some jurisdictions. The United Kingdom’s Sale of Goods Act 1979 is an example of legislation that creates statutory implied terms of description, quality and quantity of goods.

A review of the relevant provisions of the International contract shows that this contractual area is significantly more specific than the Arbitration section, leading to less flexibility but greater reliability. As conformity of products to the standard desired appears to be a fairly common-sense requirement, the level of scrutiny prescribed by the International model appears to be appropriate.

When compared to the Iranian model, however, it becomes clear that little focus is present on the issue of product conformity in the oil contract. This cannot be considered a comparative

⁴⁶⁴ The Implementing Contract is the contract specifying the rights and obligations of the parties with regard to the sale and purchase of products stemming from the Buy-Back agreement.

⁴⁶⁵ The Implementing Buyer is the purchaser of the products under the implementing contract. This is normally the original the seller under the primary contract and the buyer under the Buy-Back, but in some cases they may be a third party.

disadvantage, however, as oil contracts are extraction rather than production based and therefore the quality of the end product is uniform no matter the extraction process, as refinement is not part of such contracts.

7.8 Conclusion

An examination of the comparable provisions of the two contractual frameworks reveals a general tendency for the International model to offer greater flexibility than its Iranian counterpart, with the latter containing a number of provisions not seen within the International framework. These additional restrictions on the foreign party, particularly in the areas of Employment Regulation and Arbitration, are designed to benefit the domestic participant but the high level of regulation also decreases the commercial attractiveness of participation. Iran's interpretation of the International model is nonetheless understandable as the more general scheme is intended to cover a number of products and services, whilst the Iranian buy-back is much more narrowly focused both geographically and commercially, therefore requiring a tighter contract than the International version.

The differences in the two model contracts examined in this chapter may beget greater restrictions for foreign investors, but it cannot be denied that many of the articles focus on improving domestic expertise in the oil business. Articles 13.1 and 24 ensure that the foreign investment which Iran needs in order to utilise its resources goes back into the country, creating more jobs, more training opportunities, technological training and advancement, more Iranian experts and a modernising influence on the infrastructure of the country. Such an exchange of knowledge and technology is important if Iran seeks to increase its stature in the global marketplace at the same time as controlling and making the best use of its resources. The Iranian interpretation of the buy-back model enables investment in Iran to be rewarding for both parties

of the agreement (although Iran especially) even though the risks of exploration and management of sites fall to the contractor, these are virtually non-existent and do no great harm to the outside party. When one considers the history of the Iranian oil industry and the effect that concessions and international politics had within the economy, the level of caution used to interpret the buy-back model does not seem so excessive. Under an international contractual model, Iran would benefit far less from foreign investment while also losing the valuable exchange of expertise, training and technology that is guaranteed by the current framework. It is true that the Iranian interpretation of buy-back and the benefits accrued by this interpretation may well make investment less attractive, but in the current global climate regarding energy Iran can afford to take this risk as their massive energy resources and the low risks of prospecting still make Iranian oil an attractive concern.

Iran is the second largest oil producer still, with 11.4% of the world's oil being found there according to the most recent statistical report from British Petroleum⁴⁶⁶, and their natural gas reserves account for around 16% of the global total.⁴⁶⁷ This means that investment in this sector is a long-term plan for many, and it is this area which may prove to have been damaged by the current model for contracts. An investor will lose a significant amount of their investment when the contract runs out, such as facilities built by the contractor. Despite the harsher penalties for late delivery under the international model and a more relaxed approach to duration as whole, there is no such loss as that risked under the Iranian interpretation.

Taking into account the numerous concerns already voiced by foreign investors regarding Iran's specific implementation of the International model and having concluded that these concerns

⁴⁶⁶ British Petroleum Report September 2007 [www.williambowles.info/iran/2007/irannews_0907/irannews_09-010907.html]

⁴⁶⁷ Joint Economic Committee Report 2006 [www.house.gov/jec/studies/rr109-31.pdf]

would not largely be applicable to the principle of buy-back generally, it is reasonable to assess the degree to which the additional pressure from US-imposed sanctions may drive Iran's interpretation of buy-back towards the more attractive international model, and the subsequent implications for the global and domestic oil industry. The sanctions of the US, restricting oil investment in Iran, could have the consequence on the terms of Iranian buy-back being relaxed if they were to have an increasingly negative impact on the adoption of such contracts, and the likelihood and effect of existing and future sanctions will be assessed within the next Chapter.

Chapter 8: The Impact of the US Sanctions on Iran's Oil Contracts

8.1 Introduction

During recent times, the United States has used economic sanctions as a way of enforcing its foreign policy demands, and pursuing certain objectives. This has been done using other methods, such as pressure exerted through international bodies such as the United Nations Security Council. By using diplomatic forces and methods of coercion, the US promotes objectives it sets to achieve, such as hindering access to chemical, nuclear and biological weapons by several states.

Such policies are considerably notable in the Persian Gulf countries. Due to their abundance of natural resources such as gas and oil, they are of particular attraction to superpowers such as the United States. In Iran however, since the Islamic Republic has come into power, US demands and coercion through indirect means has not gone unchallenged. Initiated by President Carter in 1979, sanctions and other similar measures have continued, taking shape in various forms, till the present date. However, where the US allies do not side with and adequately support such policies, they tend to be unsuccessful, as this chapter will prove.⁴⁶⁸

Despite the force of the United State's underlying reasons and policy adopted towards the Persian Gulf countries, other States have defied such a policy, drawn by the potential economic advantages to be derived from relations with Iran, and other nations.⁴⁶⁹

The imposition of such a policy by the US on Iran has been varied. In the period between 1979-1988, during which American hostages were taken at the US embassy in Tehran, such sanctions

⁴⁶⁸ Some researchers have suggested that economic sanctions tend to be ineffective in the post-cold war era. See articles by Levy, P. I. (1999), 'Sanctions on South Africa: What Did They DO?' *American Economic Review*, 89, 2, 415, and Elliot, K. A. and G. C. Hufbauer (1999), 'Same Song, Same Refrain? Economic Sanctions in the 1990's', *American Economic Review*, 89, 2, 403-8.

⁴⁶⁹ Torbat, Akbar .E, 'Impacts of the US Trade and Financial Sanctions on Iran' California State University, 2005

were characterised by both political and economic isolation. By contrast, years of post-war Iranian reconstruction attracted a lot of foreign investment, and US trade sanctions were relaxed, to an extent. The Clinton Administration further induced Iran, in exercising a harsh sanction regime,⁴⁷⁰ to enter into regional trade relations with different states, increasing its trade capacity. Implementation in 1996 of the Iran and Libya Sanctions, expanding the scope of US law beyond that of its territorial jurisdiction, curbed foreign investment, but was unsuccessful in bringing it to a complete standstill. Recently, the sanctions have been subject to challenge by many states. Iran's reaction matched US action; during the Gulf-War, Iran elaborated on expansion of its trade relations with different states in order to better cope with increasing pressure, and has, notably, since the last two decades has focused on developing relations with regional trade partners, in order to reduce the effects of US sanctions on its economy.⁴⁷¹

8.2 Legal basis of the Sanctions

In order to prevent countries from trading with Tehran, Washington has equipped itself with various powers. Since the inception of the Iran-Libya Sanctions Act (ILSA), within 1996, the President of the United States retains certain powers in respect to punishing offending companies. Companies who contribute an overall sum of more than \$20 million in Iran's petroleum operations will be deemed, under the ILSA, as culpable. The President can therefore impose up to two of six sanctions: ban of company's imports and services in the US, the imposition of a maximum of \$10 million by all US financial institutions as a loan ceiling, prohibition from acting as a primary dealer of US treasury bonds, a ban on US trade assistance, and the withdrawal or denial of licences approving the trading capacity of the company.

⁴⁷⁰ Clinton announced a US embargo on all trade with Iran including the purchase of Iranian oil. See the Hearing Before the Committee on Banking, Housing, and Urban Affairs, United States Senate, The Iran Foreign Sanctions – S. 1228 (11 October, 1995, p. 2).

⁴⁷¹ Estelami, H. 'A Study of Iran's Responses to US Economic Sanctions' Middle East Review of International Affairs (MERIA) Journal, Volume 3, No. 3, Sep. 1999

Washington reserves other legal powers also, in order to enforce secondary sanctions. For instance, foreign-owned companies with access to the American market may be found culpable if conduct business with individuals, firms or governments with alleged terrorism links. Companies affected by such measures include banking groups in particular, such as ABN Amro, UBS Bank of Switzerland and Credit Suisse, who all curtailed business operations within Iran on the basis of the above legislation.⁴⁷²

The history of US sanctions may be highlighted, to reflect the legal basis. US sanctions began on 12 November 1979, after the abduction of the Shah from the throne. President Carter consequently froze all Iranian assets in the US, but such measures were revoked by the Algiers Agreement in 1981, in the spirit of general good relations. In 1987 however, President Reagan initiated the sanctions yet again, and with the passing of the Iran-Iraq Arms Non-Proliferation Act in 1992, exports of missile technology, commercial arms sale, nuclear technology and sales of dual-use items were prohibited. It provided for secondary sanctions as measures to use against the offending party. This was to be used as a model for the ILSA of 1996.

Senator D'Amato introduced the Comprehensive Iran Sanctions Act, followed by the Iran Foreign Sanctions Act, in 1995. The bill by him proposed was named the Iran-Libya Sanctions Act, and is currently still in effect. The effect of the Act is to penalize any American company investing in Iran, regardless of the amount. Foreign companies investing more than \$20 million in any one particular sector of the oil or gas industry will be penalised, under the law, also. Moderate legislators tried to ease the effects of the legislation, but were countermanded by

⁴⁷²The Independent on Sunday, UK banks caught in Iran sanctions probe, 5th February 2006, [<http://news.independent.co.uk/business/news/article343200.ece>]

strong opposition from Senator Jesse Helms. Under President Clinton, a few of the prohibitions were lifted, as regards non-oil products, however.

Saddam Hussein's downfall brought about a reinvigoration of the sanctions campaign against Iran, and in 2003, Senator Brownback introduced the Iran Democracy Act Bill, declaring support for the US to conduct a monitored referendum, in order to induce a change of regime. However, the bill remains in the committee phases, as of yet. The Iran Freedom and Democracy Support Act further tightened the sanctions regime, deterring international financing institutions such as the World Bank from offering financial assistance to Iran. The ILSA Enhancement and Compliance Act had a similar effect, in so tightening the regime.⁴⁷³

The Iran-Libya-Sanctions Act, otherwise referred to as ILSA, was extended and changed in 20 September 2006 to the Iran Sanctions Act, terminating sanctions on Libya. Originally the ILSA had been incorporated due to the policy of the Clinton Administration to deter Iran's advances in the field of nuclear armaments, and to hinder its available funds granted to terrorist organizations, made effective through Executive Order 12957, prohibiting US investment in the energy sector, and the Executive Order 12959, prohibiting investment and trade with Iran in any manner or form, issued in 1995.

The US legislation was passed in light of European and US disputes, and incorporated into the law in 1996. The aim of such legislation was to limit the amount of investment to a peak of £40 million, enforced by a policy to negate access of companies defying such a rule, into the American market. The ILSA underwent heavy criticism, and violated trade regulations. Companies including Total, Petronas, and Gazprom ignored the ILSA, and continued trade relations with Iran, agreeing to develop the South Pars gas field. In May 1998, the US found

⁴⁷³ Valibeigi , Mehrdad, Law of Unintended Consequences: US Sanctions and Iran's Hardliners, Middle East Report, Online, 28 January 2004 [<http://www.merip.org/mero/mero012804.html>] date of access: 17 October 2006

itself having to compromise the ILSA when a waiver was agreed upon to apply to the abovementioned companies. Further, EU-member companies would be immune; it was stated, from the ILSA, in matters not dealing with the Caspian oil export pipeline. The ILSA was moreover extended for a period of five years, in July 2001. Incorporation of the ILSA has had no visible effect on EU and non-EU companies, although there have been, in several instances, allegations of violations. After Senator D'Amato's departure from the Senate, the legislation lost more of its drive.

The House Bill 6198,⁴⁷⁴ introduced on September 27, 2006, in order to enforce Administrative flexibility, recommended a limit of 180 days for the determination of any violation. The Bill extended the ILSA until 31 December 2011, and further, prohibited sales of WMD technology or other advanced weaponry to Iran, and provided for the prevention of money laundering by terrorists, and criminal groups. Such a Bill, passed unanimously, signed on 30 September 2006, changed the ILSA title to ISA.⁴⁷⁵

8.3 Motives of the US Government for Institution of Sanctions

The overall effect of US sanctions on the Iranian oil industry has been to delay investment, impose extra costs on US workers and firms, and hamper US public relations as between Europe. As is argued by the present author, such sanctions have failed to change Iranian policy to a significant extent, as aimed for.⁴⁷⁶

⁴⁷⁴ The Bill codifies US sanctions on Iran, and provides for administrative flexibility in order to use the sanctions in the appropriate manner, in given circumstances, by allowing the administration a certain amount of discretion in its application. The Bill provides for presidential authority to waive sanctions, but requires the president to justify the waiving of such a sanction by proving that it is essential to US interests. Notification, 15 days before the termination of any sanctions, by the president, must be made. This Bill also incorporated amendments to portions of the Iran-Libya Sanctions Act of 1996, in relation particularly, to Libya.

⁴⁷⁵ Congressional Research Service(CRS) Report for Congress, The Iran Sanction Act(ISA), Kenneth Katzman, [<http://www.fas.org/sgp/crs/row/RS20871.pdf>]

⁴⁷⁶ Schott Jeffrey J. The Iran and Libya Sanctions Act of 1996: Results to Date, Institute for International Economics. [<http://www.petersoninstitute.org/publications/papers/paper.cfm?ResearchID=285>] date of access: 5th November 2006

Sanctions are intended to isolate the country on which they are imposed, and have a punitive nature. Such is apparent in sanctions imposed on Cuba, Libya, Iran and North Korea.

The effect of the US sanctions effectively stopped a few companies from contracting with Iranian oil companies, but most of the resulting economic problems in Iran were not the result of such sanctions, although they were aggravating to the economy, but instead were triggered by Iran's own domestic policies. Iranian oil production nonetheless managed to develop after the incorporation of the Iran-Libya-Sanctions Act, (ILSA).

US sanctions in place also aimed to coerce Iran to change its domestic and foreign policy, in line with that of the US. Although, as a result of the sanctions US firms and workers had a price to pay, in relation to the GDP of the country, such costs incurred are negligible.⁴⁷⁷

8.3.1 Future Developments

The future of US sanctions and policy towards Iran is marked by several factors, amongst them the 'War Against Terror', Iran's reactions to the Palestinian crisis, and the role Iran allegedly plays in Iraq's reconstruction and strive for stability. As such, it is unlikely that the sanctions regime be alleviated under Bush's administration.

Recently, Treasury Department officials have been attempting to negotiate a military strike in order to coerce Russia and Europe to expand the Iranian economic sanctions in order to increase effectiveness and to halt Iran's nuclear programme. They wish to strengthen Security Council sanctions against members of Iran's governing regime via means of a wide-reaching travel ban,

⁴⁷⁷ Schott, J.J., op.cit.,

and by restricting Iran's capacity to conduct business outside its territory. US officials have also been trying to force certain banks worldwide to take other measures to block Iran's progress.⁴⁷⁸

Whether such sanctions will be effective in hindering Iran's nuclear prospects is to be doubted, for, such technology has been developing for 20 years, in violation of diplomatic entreaties and threats, although they will invariably have some detrimental effects as to the efficiency of the development of such sanctions. Notably, broad economic sanctions as were previously used against Iraq in the 1990s are no longer compatible, since oil prices have risen, and therefore Iran has greater negotiating powers with other nations, despite such sanctions. Effectively, despite selling less, Iran could still earn more as few nations have the capacity to refill the void left by the loss of Iranian oil in the market.

Hence few politicians are willing to support a sanctions policy, as the effect would be to increase oil prices and trigger a potential world recession. Other nations have expressed willingness to support mild sanctions, but not broad ones. Russia in particular, is contrary to any harsh measures, as it has profited from the arising tensions with Iran and Iraq, and has seen its oil production double.⁴⁷⁹

As the US has failed to fulfil its goals of eliminating the present clerical regime, influencing Iran's foreign policy, and hindering Iran's nuclear ambitions, it is yet to be seen whether economic measures will make such goals realizable in the future.

Former US senator, Fred Thompson, stated recently that sanctions coupled with diplomatic pressure should continue to be enforced as a means of ensuring Iran's compliance the United Nations resolutions to halt its nuclear ambitions, but stated also that a blockade would be more

⁴⁷⁸ Cooper and Sanger, 'A rift emerges over US policy toward Iran', The International Herald Tribune, June 15, 2007 [<http://www.ihb.com/articles/2007/06/15/news/iran.php?page=2>]

⁴⁷⁹ Schott, J.J., op.cit.,

effective in ensuring the above aim. Such a blockade however, as suggested by the former senator, would be an act of war, and would have the impact of causing world oil prices to surge, and trigger a potential economic crisis.⁴⁸⁰

Iran, being a major oil exporter, is globally involved in the oil market, and its oil sales bring in vast earnings in dollars, to the exchange of which, thanks to foreign exchange earnings, it can buy goods and services.⁴⁸¹

The ISA is facing additional challenges. Long-term deals between Iran and Indian, Chinese and Malaysian firms may boost Iran's oil exports, hindering the ISA's objective. However, the US is not limited only to using the ISA as a means of enforcing its policy; trade regulations are being enforced in order to coerce European banks to back away from doing business with Iran, and this has had significant impact. Amro, for instance, in 2005, had been fined \$80 million for not issuing a full report in its dealing with the Iranian Bank, Melli. HSBC, Credit Suisse and Commerz bank A.G. have halted dollar transactions. These financial restrictions are having negative repercussions, particularly in Iran's ability to fund its energy industry, and Iran is looking for alternate means, such as its reserve funds, to meet its expenses.⁴⁸²

Iran's Oil Stabilisation Fund for instance, in existence since 2000, is reserved as a stabilization tool to cope with the rollercoaster nature of oil prices surging up and down in world markets, for the ensuring of fiscal discipline, and for the avoidance of over-appreciation or depreciation of the Iranian national currency, resulting from annual oil export fluctuations. Iran had also embarked

⁴⁸⁰ Blair, D., 'We Must Blockade Iran', The Telegraph, 20 June 2007, <http://www.telegraph.co.uk/news/main.jhtml?xml=/news/2007/06/20/wfred120.xml>

⁴⁸¹ Based on the work of Dr. Marvin Zonis titled "United States Economic Coercion of Iran", presented at the "Iran in Transition" conference convened by the Petro-Hunt Corporation in Dallas in May 1996. The author has the role of a Professor of International Political Economy, at the Graduate School of Business, University of Chicago. Amongst his books are: *Majestic Failure*; *The Fall of the Shah*; *Khomeini and the Islamic Republic of Iran*; and *The Political Elite of Iran*.

⁴⁸² Katzman, CRS Report for Congress, op.cit.

upon its third Five-Year Development Plan, establishing the Iranian oil foreign exchange reserve account.⁴⁸³

However, it is contended that the Parliament's recent handling of the OSF has demonstrated the lack of usefulness a rainy day fund scheme⁴⁸⁴ has, since it has been used unreservedly, and rather casually for other purposes. Further, due to the present political realities, it is not unnatural for the government to be unable to resist political temptation to make use of the funds.⁴⁸⁵

8.4 The Impact of Sanctions on the US Economy

The US Sanctions on Iran impacted the US economy both directly and indirectly. As a result of such sanctions, the US underwent a losses caused by the decrease of bilateral trade. Such losses, calculated on the basis of totalling the GDP's of the primary participants in the country's economy, namely, Germany, France, Italy, China and South Korea, shows that they amount to roughly \$12 trillion.

Iranian imports from its trading partners amounted to an estimate of \$4.3 billion, in 2000, and further increased in 2002, where its imports rose from \$12.7 to \$21.2 billion by 2003, according to data collected by the Central Bank of Iran.

⁴⁸³ Article 60 of the Third Five-Year Development Plan established, in affiliation with the Central Bank, a "crude oil foreign exchange reserve account" in order to stabilize the annual budget.

⁴⁸⁴ Lessons learned indicates that an oil stabilization fund work most effectively as a stabilizing and balancing force where the country rich, politically stable and enjoys a low inflation. In Iran, a country characterized by low middle income per capita, and budget deficits of 5% of the GDP, such a fund is not very effective, and can be a potential inflation triggering device.

⁴⁸⁵ Amuzegar, J., 'Iran's Oil Stabilization Fund: A Misnomer', *Middle East Economic Survey*, Vol. XLVIII No 48, 21 Nov 2005, [<http://www.mees.com/postedarticles/oped/v48n47-5OD01.htm>]

In exchange, \$7.1 billion of services and goods, by Iran's major trading partners, assuming fixed percentage shares of the trading partners, was imported to Iran. Assuming instead that Iran would have imported such an amount in dollars, then consequently the United States is forfeiting \$6.2 billion every year, in the form of exports, as a result of their sanctions policy. Following ILSA's ratification, the volume of US exports to Iran dropped to near zero, but have recouped itself recently, in 2003, amounting to \$93 million. The burden of lost exports has been borne by the wheat producers of mid-west US states, aircraft manufacturing companies such as Boeing, and power generating companies. Prior to the 1979 revolution, the United States had been the country's biggest wheat supplier, and Iran subsequently, the largest wheat importer. However, through the ILSA mechanism, and the policy of hardliners in the Iranian governments, the trade in wheat remains blocked by both parties.⁴⁸⁶

Iran however, as one of the top five global oil producers, is still within reach of many oil companies who remain undeterred by the US policy. US companies have often violated the sanctions. Conoco, for instance, in 1995,⁴⁸⁷ when coerced by the Clinton administration to stop investment in South Pars Offshore oil fields, opposed such measures.⁴⁸⁸

Other European and international oil companies have refused to be restrained by such measures, and the European Union in particular, encourages companies to ignore the ILSA and its policies. TOTAL, Gazprom and Petronas have consequently replaced Conoco in the South Par oil field. France put up a confrontational resistance in 1998, in relation to US sanctions policy, as a result

⁴⁸⁶ Valibeigi, op.cit.,

⁴⁸⁷ President Clinton, in the March and May of 1995 had signed two Executive Orders calling for the prohibition of US firms and related entities outside the US, entering into business relations with Iran. Executive Order 12957 prohibited all contract[s] dealing with petroleum resources located in Iran. As an effect of the the March 1995 Executive Order, but before the ILSA enactment, Conoco, an US based company, was obligated to terminate a \$550 million obligation to exploit Iran's Sirri A and E offshore oil and gas fields. Two years later, President Clinton signed another Executive Order 13059 strengthening the notion that practically all funding and commerce was prohibited, by US citizens in Iran.

⁴⁸⁸ Pomeroy, William. Cordesman, 'The US in Iran, outflanked and out of touch'2000, CSIS, The Guardian March 31, 1999[<http://www.pww.org/past-weeks-1999/The%20U.S.%20in%20Iran.htm>]

of which TOTAL was exempted from the reach of the ILSA. Competing companies such as Mobil and Exxon were infuriated by such a move, as they too, had been eager to settle oil deals in Iran.

The NIOC has triggered investment moreover by offering 43 oil and gas projects, and consequently 30 companies from 18 countries (including a Los Angeles company), attempted to negotiate for the deals. France and Italy settled such deals with Elf Aquitaine and ENI, defying US policy out right.

This was an important step in expanding Iran and opening it up to foreign investment globally, and regionally, and in securing partners other than the US. Australia followed France and Italy's lead, and embarked on ministerial visits to Iran in order to expand relations. In such a way, US policy was undermined, and its trade boycott was largely discredited. Further, the change of the political scenario in the US is further weakening the future prospects of the ISA.⁴⁸⁹

Research conducted at the Institute for International Economics demonstrates the effect of the sanctions on jobs, wages and trade within the US. American exports to the twenty six states being affected by trade measures, in 1995, diminished to a threshold of \$19 billion below the expected level. The loss of such exports would invariably lead to a figure of 200,000 of job reduction, and cause the loss of up to a billion dollars in salary bonuses alone for American employees. From such facts it is visible that the longer such a sanctions regime remains in force, the more the US workers will be affected, due to the larger losses they will face.⁴⁹⁰

US sanctions have triggered objections also in relation to violation with its commercial commitments to the World Trade Organization (WTO). At this organisation, the EU has

⁴⁸⁹ *ibid*

⁴⁹⁰ Schott, J.J., *op.cit.*,

submitted a case, regarding the Helm-Burton Act in relation to Cuba. The EU contends that sanctions will not prevent a country from developing its nuclear industry and capacity, and that they can easily be evaded if a country is willing to do so. Through the smuggling of goods and sea and air freight, billions of dollars may still enter Iran, despite the imposition of sanctions, as previously occurred, with Saddam Hussein's regime. Of course, sanctions did have a detrimental effect against Iraq, in that they were respected also by large nations such as China and Russia, and effectively thwarted Saddam Hussein's nuclear program. However, it is to be remembered that such measures were in place at a time when oil prices were still fairly low so that the world economy did not feel harsh repercussions; now, due to changed circumstances and the resulting high oil prices, the situation has dramatically changed. Oil prices nowadays are near record level.

The increasing controversy of economic sanctions used as a foreign policy tool is visible in the 1990's. In 1998, for instance, in the Overseas Development Institute (London), the conference held by Britain's Department for International Development yielded the following result; that US sanctions in Iran are not effectively operative due to the current global economy being highly integrated. Thus, the US has been facing pressure, especially from countries friendly to America within the EU, to re-evaluate the sanctions policy.

Iran's expansion into trade relations with other countries has yielded productive results. For instance, in 2000 TotalFina/Elf settled a \$2 billion agreement to exploit the South Pars oil reserves, and Royal Dutch/Shell likewise settled an \$800 million deal for the development of the Soroush and Nowrooz oilfield, respectively. Further, ENI/Agip, by acquiring 38% share in the Balal fields, and Statoil contracting with the NIOC for oil exploration in the Strait of Hormuz, helped expand Iran's trade relations. In 2001-2002, moreover, Shell bought part of the Soroush-Nozrooz development, and a consortium of Japanese companies recently has purchased a share

in the same project. All this goes to demonstrate Iran's expansion of trade relations, developing strongly, despite the sanctions which are currently still in force.

Further, in 2005, Iran, by attracting \$5 million in investment, formed by joint ventures and petroleum agreements, continues to steadily progress along its development path, particularly in relation to its oil industry. The Middle East Economic Digest contends that investment is predicted to peak to \$20 billion more, by 2013.⁴⁹¹

Canada, the US's largest trading partner, has also contributed to criticisms headed by the European Union, and directed at the United State's ILSA. As a result, the effects of the ILSA, particularly after the negotiating powers of the European Union, encouraging companies established in its member states to defy such a policy, have been more or less nullified to an extent.

A second issue which is still pending, is that of the Baku-Ceyhan oil pipeline as an alternative to the Caspian basin oil export pipeline to Iran, which has repercussions on Iran's economy.

Relations between the European Union and Iran are largely politically tied, and in the future the European Union would be able to exert significant influence over Iranian policy. Such relations have been boosted, not solely due to US sanctions and policy, but by the competition element presented by other nations. A Japanese consortium for instance, is rated as the foremost candidate for oil development at Azadegan, and has chose to collaborate with Shell, which would accord it protection against the ILSA.⁴⁹²

⁴⁹¹ Valibeigi, M., 'Law of Unintended Consequences, op.cit.

⁴⁹² Schott, Jeffrey J. Op.cit.

8.5 The Relative Successes of Sanctions

It has been argued that the sanctions had limited effect on Iranian oil production, and its economy. Japanese and Italian energy groups have concluded contracts with Iran, ignoring the ILSA completely. Eni's Chief Executive Officer contends that the relationship between the Italian company and Iran prevailed over US restrictions, due to deep-rooted trade relations present between the two countries.

European and Asian companies have not been hesitant, in the light of the US sanctions, to enter into trade relations with Iran, boasting the world's third largest oil reserves.

Japan for instance, as aforementioned, is not only the foremost candidate for developing the Azadegan oil field in the south west of Iran, but, as stated by Hiranuma, the Japanese trade and industry minister, Japan hopes that by so doing, and by the conclusion of future transactions, cooperation with Iran in the oil development industry will be strengthened. When stating that domestic interests override those of the US and the consequent pressure the US exerts on the international sphere, the Minister was voicing a commonly shared opinion amongst other trading nations in the globe, with Iran. It is to be noted that such a project has yet to be finalised due the influence of US sanctions. Iran is currently contemplating withdrawing the deal from Japan, due to the ongoing delays for the initiation of the development project.⁴⁹³

Many US firms have expressed regret towards the sanctions, which have the effect of denying them access to Iran's energy fields, unlike their non-US counterparts. The sanctions have also

⁴⁹³ Islamic Republic News Agency, 30/09/2006 [<http://www2.irna.com/en/news/view/line-22/0609308102162400.htm>]

had repercussions on the US economy, costing the US billions of dollars per annum, and increasing unemployment amongst American workers, who, as a result of the sanctions, lost their jobs.

However, the sanctions did inflict economic mishap to the Iranian economy. For instance, during the first three months after the ban took effect, the sanctions cost Iran a grand total of \$100-200 million, as an estimate. Despite having found alternate sources of trade, Iran still had to sell its oil at a discount to the price it would have had prior to the ban.

Banks and governments alike have become cautious and more reluctant to assist Iran and its efforts for development, making its foreign investment prospects dimmer. Furthermore, the sanctions also caused a collapse of the Iranian currency, thereby decreasing the value of exports. Non-oil exports in particular, have been hard-hit by this fact, as their value has diminished by 75%, exacerbating the state of the foreign-exchange debt. Iran cut back its imports in an effort to pay off foreign debt, and as a consequence of its amassed debt, made less money for imports of materials and equipments. Factories therefore also, due to shortages, were forced to reduce production.

Despite all such effects, the sanctions may however be viewed as a failure, as they brought about none of the change of behaviour which they originally envisaged. It is contended that these sanctions, despite having effects and repercussions on the economy, failed to attain their central objective, that of coercing Iran to behave in a certain way. This is largely because of globalization and lack of support for the US sanctions policy. It is contended largely that when a nation such as the US attempts to punish other countries, diplomatic relations between the US and those respective countries will obviously be strained, and such relations may have negative

repercussions on the global trading system, which would contribute to its general lack of health.⁴⁹⁴

8.6 The Impact of US Sanctions on Iran

US sanctions imposed upon Iran have been enforced since the Islamic Revolution of 1979, when Iranian oil imports were banned and President Carter ordered a freeze on all Iranian assets held in the US.⁴⁹⁵ Further sanctions came into force in 1996 when the Iran-Libya Sanctions Act (ILSA) was passed by the US congress.

It is argued frequently by the International Institute for Economics that sanctions rarely work in the way in which they are intended.⁴⁹⁶ In this chapter an analysis of the sanctions on Iran and whether they are effective in limiting Iran in the global market is presented, with particular reference to oil sanctions and the probable future developments in this area.

8.6.1 The general effect on Iranian Economy

A few companies have been hesitant in investing in Iran, deferring biddings, and several agreements for the exploitation of petroleum in Iran have fallen behind schedule. This has been partly due to US sanctions, but has mostly been caused by domestic problems within Iran and its policies. Whether such delays will impact Iran's long-term production is questionable, but the answer given is that it probably will not. For US policies to achieve its goal, investment would need to be drawn away for another 10 years at least, and oil revenues would have to be curtailed, and neither is likely, in the given circumstances, to happen. Until Iran reserves its access to the global world market, it will be able to sufficiently maintain itself and its current production by

⁴⁹⁴ Schott, Jeffrey J. Op.cit.

⁴⁹⁵ Valibeigi, M. Op.cit.

⁴⁹⁶ Institute for International Economics, Case Studies in Sanctions and Terrorism Case 84-1 US v. Iran, 2001 [www.iie.com/research/topics/sanctions/iran.pdf]

producing export earnings in dollars. Indeed, it is notable that, despite sanctions, oil production has risen in 1996 from earlier periods. Sanctions imposed by the US in 1995 to 1996 did bear some costs on the economy of Iran, and the NIOC consequently strove in order to offer incentives for the fulfilment of contracts, previously reserved to US firms, with external parties. Notably, however, such costs were offset by the higher oil prices, and thus, the higher amounts that Iran received for its exports, due to increasing demand and lower supply, in the world oil market. It is further contended that if US sanctions were more successful in its aim, at curtailing investment, then Iranian revenues may be further pushed up due to higher oil prices in the world market.

Currently, Iran exports 2.6 million barrels of oil daily, and every dollar's boost in oil value corresponds to an increase of \$1 billion in profit for Iran, annually. The revenues derived from the oil market largely fund Iran's economy, which, despite US sanctions, expanded at a pace of 3.5 to 4%, during the past two years, and further, benefited from a large trade surplus, reaching \$18 billion in 1996, and an imports cutback. Moreover, by rescheduling 50% of its debt, it lessened its debt demands, and secured \$5 billion from several countries, including Germany, for industrial projects within the country.

As can be seen from the above, therefore, allowing costs and losses to be incurred on Iran may be satisfy the US in the short-term, but in the long run it will not necessarily affect the Iranian economy all that much. Further, as has been viewed, the price of such sanctions in itself affects the US significantly, thereby, over time, reducing support and popularity of such a regime, domestically within the US.⁴⁹⁷

⁴⁹⁷ Schott. J. J. *op cit*.

Further, in 1997, a study conducted by the Institute for International Economics drew upon the conclusion that the success rate of unilateral US sanctions in achieving foreign policy goals is only 13%. The study also indicated that the sanctions cost the US \$15 to \$19 billion per annum, as a result of the loss of potential exports.⁴⁹⁸

8.6.2 Iran's Oil development

Iran has been a major player in the global oil markets and is currently the largest oil producer and exporter amongst the OPEC countries. Iran's daily production of oil is 4 million barrels, of which 60% is exported world wide. Iran has unsurprisingly contributed to recent developments in the global oil market; oil prices have risen thanks to increasing demand, particularly in areas such as China and India, coupled with declining production in the OECD region, and security issues arising in Iraq and Nigeria, who are also major oil producers. Despite increased oil production and export by Russia and Saudi Arabia, demands have not yet been satisfactorily met, thereby causing an increase in prices.

During the last decade, Iran on average exported roughly 2.5 million barrels a day. Recently however oil prices has risen four times the price a decade ago, to about \$60 per barrel of oil, and as a result, Iranian oil exports have increased to more than \$46 billion in 2005, from a meagre \$15 billion in 1995. Iran now receives an increased amount of \$30 billion, more than that which it received ten years ago.

The US has tried to demean the power of Iranian adventurism, through sanctions and diplomatic measures. Overall, however, as has been seen, the ILSA has failed to meet its objective. Recently

⁴⁹⁸ Mostashari, Ali, 'The Impacts of U.S. Sanctions on the Iranian Civil Society: Consequences for Democratization' 01/09/2004 [<http://www.payvand.com/news/04/jan/1056.html>]

some US politicians have been demanding a stricter sanctions regime, including a military response, in reaction to Iran's steadfast nuclear programme.⁴⁹⁹

8.6.3 The Impact of US Sanctions on Oil Exports

Iran's oil export in 1994 was 2.6 million a day, at the estimated value of \$13 billion per annum. Of this amount, the US companies purchased 600,000 barrels a day, of the value of \$3.5 to \$4.0 billion per annum.⁵⁰⁰ This ended in 1995, with the imposition of US sanctions on Iran. Companies were unable to buy Iranian oil, despite the fact that it would not be imported into the United States.

Iran suffered a few temporary, but however, negligible losses for costs incurred by Iran for the storage of oil in places such as the South African coast. It was not long nonetheless before Iran was able to sell its oil to alternative buyers, due to the quality of its oil, and the increasing world demand for oil. American companies strove to negotiate deals with other oil producers, as a result of the embargo.

Due to the alternative buyers Iran effectively found, the oil import sanctions were not effective, and did not have long-term repercussions on Iran's oil production or economy. As can be deciphered through the application of the Price Leadership model to the OPEC cartel, under which Iran is considered a fringe firm in competition with other firms, around the dominant firm, that being Saudi Arabia, oil prices do not change as a result of the oil embargo because of increased competition of other oil exporters, who are also in the competitive fringe. The model shows the demand curve for Iran to be very elastic, and demonstrates that Iran may sell its whole export supply at Saudi Arabia's set price to other countries. Based on this model, and also the

⁴⁹⁹ Schott Jeffrey J., *op.cit.*

⁵⁰⁰ Senate Hearing, The Comprehensive Iranian Sanctions Act of 1995 – S. 277 (1995, p. 24).

practical repercussions brought about by the US embargo, it is safe to conclude that in the long-run Iran was affected very little by the oil embargo.

The addition of all losses from the resulting sanctions of US exports to Iran, that being \$82 million, and of all the imports from Iran to the US, being \$58 million, amounting to a total of \$140 million per annum, is the loss Iran effectively faced as a result of the US embargo.

In turn, the impact of financial sanctions may be analyzed. For such an analysis, a better understanding of debt flow and equity capital flow to and from Iran will have to be attained.

The US sanctions contained a few measures, of a financial character, designed to restrict financing from the Export-Import Bank, loan guarantees, export credits, and export insurance, to Iran.⁵⁰¹ US representatives in institutes such as the International Monetary Fund, World Bank, the International Development Association, and the Asian Development Bank, further had also been trained to vote against the extension of financial assistance, in all forms, to Iran.

Such financial obstacles started in 1984, and were further reinforced by the sanctions in 1995, with the blanket prohibition of all transactions of a financial and commercial character with Iran. The financial measures did undermine Iran's financial flexibility to a large extent, and Iran was coerced in finding other ways to exercise its financial freedom and financing, incurring costs higher than it would have, if the previous methods of financing had been available.⁵⁰²

⁵⁰¹ The Iran Foreign Sanctions Act – S.1228, Hearing before the committee on Banking, Housing, and Urban Affairs Washington, 2 Editions, October, 1995, pp. 25–47

⁵⁰² Torbat, A.E., 'Impacts of the US Trade and Financial Sanctions on Iran' 407, (2005)
[www.blackwell-synergy.com/doi/pdf/10.1111/j.1467-9701.2005.00671.x] date of access: 2nd October 2006

Table 5: Top Ten Iranian Crude Oil Export Destinations

| <i>(barrels per day)</i> | | | | |
|---------------------------|------------------------|------------------|------------------|------------------|
| Rank | Reporting Country | 2003 | 2004 | 2005 |
| 1 | Japan | 685,034 | 630,462 | 570,604 |
| 2 | China | 247,235 | 263,446 | 284,830 |
| 3 | South Korea | 171,563 | 173,144 | 195,654 |
| 4 | Italy | 194,055 | 188,033 | 193,935 |
| 5 | France | 115,209 | 128,892 | 142,811 |
| 6 | Netherlands | 130,214 | 138,751 | 139,246 |
| 7 | Turkey | 138,683 | 114,217 | 138,873 |
| 8 | South Africa | 118,695 | 189,613 | 134,646 |
| 9 | Taiwan | 167,003 | 138,518 | 125,031 |
| 10 | Greece | 88,781 | 115,533 | 105,236 |
| | Reporting Total | 2,056,472 | 2,080,609 | 2,030,866 |
| | OECD Pacific | | | 728,320 |
| | OECD Europe | | | 826,584 |

Source: Global Trade Information Services, Inc., Global Trade Atlas, July, 2006.

8.6.4 The Effect on Iranian Politics

US sanctions have caused a rise of anti-US sentiments within the nation, and have been used to an extent against democratic institutions within the country itself, which wishes to retain a more prominent place in Iranian politics and society.

The embargo additionally also gave a few hardliners in Iranian politics the opportunity of using the policy as an excuse for domestic mismanagement of the Iranian economy, beginning well before Khatami's rise to presidency in 1997.

The political effect of American trade measures on Iran manifests itself in that the public sector overwhelmingly outdoes the private sector, prevailing over it, in the economy, and the economic gains brought about by the public sector, driven by state subsidies, is the sole driving force of the economy. Such gains have vastly benefited the conservatives, who partake in such profits.

Moreover, amongst the business community, it is a well known fact that without paying sums of money to national or local political figures and government administrators, the probability of success in establishing enterprises is quite low. Such lack of competition, have attracted bribery, speculation and monopolistic tendencies within the economy and nepotism. Government subsidies further, for gasoline and food, have allowed many businessmen to thrive. Many have also been involved illegally in such transactions regarding the subsidized commodities, such as the in the distribution and purchasing.

The public sector's economic activities are also quite significantly overseen by organisations closely linked to the Revolution, such as Mostazafan Foundation, contributing to the establishment of an economic base for the political conservatives within Iran, and in assisting the pushing through of their agenda.

The Institute for International Economics, (IIE), has concluded in its studies that sanctions, and particularly those of a unilateral nature, do not operate normally in the way they are intended to. In a global economy, such sanctions are not very effective, as the target government can look elsewhere to fund its needs. The sanctions do have the effect however of imposing extra economic hardship on the poorer people of the country, but do not generally tend to change the regime or policies of the government.

In terms of limiting the Iranian government's nuclear programme, the sanctions are a complete failure, as companies in Europe have replaced much of the former US partners, and have continued investing in Iran. Iran has exported oil to the value of 6.7 billion euros to the EU, and imported 6.6 billion euros worth of goods and services into Iran. Iran's ability to procure equipment for its nuclear stations, or goods, such as closed-circuit televisions and satellite software, from countries such as Russia and Pakistan has gone unfettered, as a result of the sanctions.

The sanctions have, nonetheless, been successful in having a punitive impact on the Iranian community. Iranian planes are dilapidated, involving higher risks for passengers. Consumers often purchase goods at three times their original price. Students are unable to enrol themselves in American universities or take American standardised tests. Iranian academics cannot publish their work in US-based scientific journals.

Further, the political effect of the sanctions has been that conservative hardliners in Iran have attained a tighter grip on Iran's economy. Due to reduced channels of trade, control over certain assets has been facilitated, and this has hit Iran's public sector very hard. The Mostazafan Foundation, and many others are involved in such dealings. Moreover, sanctions have allowed the government an excuse for their own economic mismanagement.

The overall effect of sanctions, politically speaking, within Iran has not been a regime change triggered by dissatisfaction with the current regime. In fact, the effect, as has been seen, is quite radically different. Sanctions have effectively pushed the economy into the grips of hardliners, who use sanctions as an excuse for certain repressive policies, by them adopted.⁵⁰³

⁵⁰³ Payvand, 01/09/2004 [<http://www.payvand.com/news/04/jan/1056.html>]

8.6.5 The Effect on Trade

The sanctions caused Iran to significantly change its trading patterns, and realign it. In 1980, for instance, the sanctions, although very brief, caused Tehran to search for other trading nations. Iran avoided, in its quest to find new partners, countries such as Germany, France and Britain, and Japan during the time, as they were afraid of US influence over such countries.

Because of diminishing connections with the US, trade between Iran and countries particularly in Eastern Europe, of the Islamic world, and between non-aligned nations significantly increased.

The 1979 constitution of Iran further provided that the government tightly manage the control of international trade for Iran, and also provided that any private sectors importers would have to seek government authorization from certain agencies in order to be able to trade, thereby marking a drastic government influence on Iranian trade and particularly Iranian imports.

Bilateral trade agreements also made the conducting of international trade much easier. Whilst previously the US had been Iran's dominant wheat supplier, such a role was replaced by New Zealand and Australia. Other import requirements of meat, iron and sugar were satisfied by European countries, namely, Sweden, Italy, and Denmark, including a few ex-Soviet Union nations, such as Yugoslavia, Romania and Poland.

The Iranian government further initiated several formal schemes in order to regulate existing trade imbalances with a few OECD countries, by taking measures such as restrictions on the amount of imports permitted from several specific nations, for instance, like Japan, the UK and Germany, and in regulating the exports respectively also, to such countries.

Increasing government control of Iran's trade brought about a predictable pattern of diversification of trade relations. Imports from the US and European countries diminished

rapidly, from an 80% prior to the Revolution, to 63% after it, and continued diminishing steadily afterwards, also. By 1996, US imports into Iran had decreased to zero, Japan and European countries constituting only 50% of Iranian imports. In the same year, imports from other countries increased by more than 8%.

Table 6: Share of Iranian Imports by Source Traditional Suppliers⁵⁰⁴

| Time Period | United States | Western Europe | Japan | Other |
|-------------------------------------|---------------|----------------|-------|-------|
| Pre-revolution (1975-1978) | 18.5 | 48.7 | 15.8 | 17.0 |
| Revolution and Iraq War (1979-1988) | 1.8 | 47.8 | 13.0 | 37.4 |
| Post-war Reconstruction (1989-1992) | 2.1 | 52.1 | 11.4 | 34.4 |
| Dual Containment (1993-1996) | 3.3 | 45.8 | 8.3 | 42.6 |
| Iran-Libya Sanctions (1996-present) | 0.0 | 44.9 | 6.4 | 48.6 |

After the Iran-Iraq war, a more liberal foreign trading policy was adopted in Iran. In fact, several measures facilitating trade were incorporated, and a new plan aimed at developing the war-shorn industries was prepared. Washington too, appeared to react to Iran’s policies in a more liberal way. The early part of Bush’s presidency foresaw a relaxation in the sanctions regime;⁵⁰⁵ \$600 million of Iranian frozen funds in the US were released, and a significant amount of Iranian oil was agreed to be imported into the United States. Further, Americans carried out exports to Iran, and American companies had in fact become the most significant trade partner in Iran for oil. However, in August 2001 George Bush signed an extension on ILSA of an additional 5 years.

⁵⁰⁴Estelami, H. Middle East Review of International Affairs (MERIA), A Study of Iran’s Responses to U.S. Economic Sanctions. Vol.3, No. 3, 1999

⁵⁰⁵ Dick Cheney, the then Republican vice-presidential candidate, called for “an end to investment sanctions against Iran”, in a speech given at the World Petroleum Congress in Calgary, Canada. Reported by Reuters, 14/06/2000.

Iran, being the second largest OPEC member, has always been very dependent on its oil export revenues, which have served as its main source of foreign exchange, and the war had consequently affected not only oil fields but many of Iran's facilities in and around Iran. The 1986 oil crude prices collapse demonstrates the extent to which Iran depended on oil. After the war, Iran's focus on the expansion of industries, and means of exportation was central to its redevelopment and restructuring.⁵⁰⁶

8.6.6 The Impact on Foreign Aid to Iran

In the 1960s, Iran had been a major borrower from the World Bank, but stopped doing so in 1975 due to increasing oil prices, as the revenues generated by oil exports made Iran independent, and it no longer needed to recur to foreign financing to meet its economic demands. The establishment of the Islamic Republic in turn brought about a zero-tolerance policy towards foreign assistance and borrowing. However, the Iran-Iraq war left the Iranian economy in tatters and in need of assistance of capital in order to redevelop its economy and therefore necessitated borrowing from the World Bank, despite the Islamic Republic's no-borrowing policy. Iran borrowed a sum of \$250 million for earthquake damage and at the same time agreed to assist the freeing of American hostages held in Lebanon, and another sum of \$847 million from the World Bank for development projects.⁵⁰⁷ Borrowing more money in the 1990s, by 1993, Iran had accumulated roughly \$30 billion of foreign debt to pay back, and was in a state of financial difficulties.⁵⁰⁸ Unable to repay its short-term debt, it had to renegotiate the terms of the payback of its long-term debts, which was further hindered by US efforts to prevent Iran's presence at the Paris Club in order to facilitate its rescheduling of debt. This effectually forced Iran to find

⁵⁰⁶ Estelami, H., Op.cit.

⁵⁰⁷ World Bank News Release No. 2000/352/S (May 2000).

⁵⁰⁸ 'Waking Up From A Nightmare', *The Banker* (September 1993, pp. 43–48).

alternate, harsher means, in terms of bilateral agreements, of renegotiating payback.⁵⁰⁹ During this time also, Japan halted a previously agreed upon project worth \$460 million for the building of a hydroelectric project in Iran, and the US managed to exert its influence in order to make sure no further loans were offered to Iran. The US also instructed its representatives, under an US anti-terrorism law requiring country representatives to vote against loans from all organizations to countries allegedly supporting terrorism,⁵¹⁰ to boycott loans to Iran in a similar fashion.

In 1998, Iran underwent another period of amassing debts, as oil prices decreased and it strove with an effort to maintain imports and investments within its development programme in order to be able to dissipate its debt. In 1999, in fact, faced with difficulty, Iran converted short-term debt to a long-term loan, and in the same year, its promised loan of \$200 million from the World Bank was halted when thirteen Iranian Jews were arrested in Iran, for espionage charges.⁵¹¹

The World Bank's response at receding under US pressure further diminished the Iranian reputation of repaying loans, this made conditions harder at a time of financial crisis. US objection to such loans from financial institutions such as the World Bank has persisted, and has not declined, until the present day.

It is to be noted that US influence over bodies such as the World Bank is not unlimited; the US's voting share in the aforementioned organization is 17%, and without the assistance of other countries, its means of coercion by use of its vote and other diplomatic measures, fails miserably. On 18 May 2000, for instance, contrary to US objections the World Bank issued to loans in Iran's favour, following seven years of no granting of loans. This goes to prove that US methods

⁵⁰⁹ Senate Hearing, *The Comprehensive Iranian Sanctions Act of 1995* – S. 277 (1995, p. 5).

⁵¹⁰ The Iranian regime has been accused of involvement in several terrorist incidents and assassinations including Shahpour Bakhtiar, the former Prime Minister of Iran and a number of other political leaders and dissidents as well as over 45 Iranian opposition leaders. None of these incidents have been proven in court with the exception of the execution of three Kurdish dissidents who were killed in a Berlin restaurant in September 1992 on the order of Ali Fallahiyani, Iran's Minister of Intelligence and Internal Security.

⁵¹¹ 'Loan to Iran Stalls after Arrest of Jews', *Washington Post* (23 June, 1999, p. A18).

at preventing foreign aid and assistance in Iran, although effective, have not always been so, and is dependent on numerous factors.

Post-revolution Iran was characterised by the drainage of a lot of the educated classes, leaving Iran for other places, such as the US. This has had repercussions on the economy, as many of such migrants have funds which could possibly be invested in Iran, and which haven't been. However, foreign funds have been received primarily through buy-back contracts, inducing development projects in the country.⁵¹²

8.6.7 The Impact on Financing Oil Projects

The dominant impact of sanctions has been a decrease in the funds Iran has seen for the development of its oil projects. Due to the highly capital incentive nature of the oil industry in Iran, a lot of investment is required for the developing of such an industry. A lot of the Iranian oil industry, such as onshore oil fields, is in dire need of redevelopment and restructuring, due to the Gulf War. Further, Iran in the past faced the need to develop several of its untapped fields. Such development work required capital which Iran lacked, and which, due partly to US policy, was unable to receive in the form of debt or loans. Moreover, due to the ban, in accordance with the Islamic Republic Constitution, of foreign ownership of natural resources, buy-back contracts were adopted by the NIOC in order to make use of its facilities, and open up access to international oil companies to generate some revenue.

Iran, in order to finance its oil development stratagems, from 1991 offered access of its oil fields to international oil companies, with a rate of return of 10% for all buy-back contracts. Since reserves are guaranteed, contracts are free of risk and Iran argued that the rate of return therefore ought to be similar to bond rates of the time. Several international companies had certain

⁵¹²Torbat, A.E., 'Impacts of the US Trade and Financial Sanctions on Iran' 407, (2005)

reservations regarding the political situation and particularly political instability of the country and were generally speaking dissatisfied with the offered rate, which they thought should be closer to 20%.⁵¹³

Several oilfields were well known in Iran, particularly because of their wealth. However, as a result of the financial crisis facing Iran in 1993, many of the field projects previously entered into had to be halted. These were also aggravated by the sanctions imposed by the US. As a result of all these problems, in 1995 the NIOC found itself having to offer certain incentives in order to attract foreign investment, as is reflected in their contract rates for buy-back contracts.

Furthermore, an Oil and Gas Conference was held in Tehran in order to open up access to negotiations for more buy-back contracts to many potential parties, present at such conferences, in 1995.

Contravening US sanctions, 40 foreign oil, gas and engineering companies attended the conference, but few proceeded to embark upon such contracts, with looming US threats on the horizon and the ILSA taking effect in 1996. American investment in Iran was prohibited by President Clinton's invoking of the International Emergency Economic Power Acts and the ILSA. The former measures prohibited all US persons from embarking upon projects for the development of Iranian oil resources, and from exporting technology, goods or services to Iran, including certain goods of US origin exported via another country. Under the latter measures companies contributing total sums greater than \$20 million per year in any one of Iran's petroleum sectors would face liability.

⁵¹³ Odone, Toby, 'Iran: A Test Case in Opening Its Oil Fields to Foreign Investment in the Slow Way', paper presented at the Institute for Global Management & Research, George Washington University, DC (October 1998).

Most of the important contracts offered by Iran to international firms and companies, since the April 1995 are listed in a table below.

The terms of buy-back contracts remain confidential, with details not disclosed to the Iranian Parliament either.⁵¹⁴ The figures as present in the table below derive from certain information released on various occasions to the media. Since the inception of 2001, Iran has a total number of buy-back contracts to the estimated value of \$9 billion.

⁵¹⁴ The Petroleum Finance Company, Upstream Brief (21 January, 2000).
The terms of the buy-back contract are explained in this industry newsletter: “The foreign contractors submit development plans with a cost estimate. The contractors then negotiate a contract whereby the foreign contractor fully funds development. Once production commences, the contractors are allowed to recover development costs, interest on capital expenditures, and a remuneration fee (service fee). The amount of the remuneration fee is such that the contractor recovers capex over a 3 to 5 year period with the fee providing 20% (±3%) internal rate of return”.

Table 7: The Main Oilfield Subject to Buy-Back Contracts

| Field | Description | Reserves | Current Output | Companies involved | Dates |
|-----------------|--|--------------------|---|---|---------------------------------------|
| Abuzar | | | 140,000 bpd | | |
| Abuzar | Offshore, Persian Gulf | | | | |
| Agha Jari | Onshore, located in Khuzestan | | 200,000 bpd | | |
| Ahwaz-Asmari | | | 700,000 bpd | | |
| Ahwaz-Bangestan | Onshore. Includes Anwaz, Mansuri and Ab-Teymour. Located in Khuzestan (SW region). | | 250,000 bpd, with plans to increase to 600,000 bpd over the next eight years. | TotalFinaElf, Shell, Eni and BP are bidding. | |
| Azadegan | Onshore, located in Khuzestan | 24 billion barrels | Potentially 300,000-400,000 bpd | Japex and Indonesia Petroleum, with the controlling stake owned by Japan National Oil Company (JNOC). | Discovered 1999 |
| Bahregan | Offshore, Persian Gulf | | | | |
| Balal | Offshore, Persian Gulf | 105m barrels | Expected to reach 40,000 bpd | Bow Valley Energy (15%), TotalFinaElf (46.75%), Eni-Agip (38.25%). | Discovered 1970, contract signed 2001 |
| Bibi Hakimeh | Onshore, located in Khuzestan | | 130,000 bpd, to increase to 170,000 bpd | | |
| Caspian Sea | Oil Rig off Mazandaran Province; Iran has declared it would search for deposits within the 20% of the aquatic territory considered to be its own | | | NIOC | Contract signed 2001 |
| Cheshmeh- | | | 30,000 bpd, to | Cepsa; expected to | |

| | | | | | |
|--------------------------|---|---|--|--|--------------|
| Khosh | | | rise to 80,000 | rewarded to Cepsa and OMV | |
| Darkhovin | Onshore | | Expected to reach 160,000 bpd | | |
| Darquain | Onshore, Awhaz region. | | 50,000 bpd, peaking at 160,000 bpd | Eni (60%), NICO (subsidiary of National Iranian Oil Co., or NIOC), 40%, NIOC to be in charge during exploitation phase. 8 wells, gas injection, oil processing plants. | 2001 |
| Dasht-e Abadan | Offshore, nr Abadan | 24 billion barrels | | | |
| Doroud | Oil and Gas, offshore Kharg Island, Persian Gulf | | Currently 136,000 bpd; expected to reach 220,000 bpd | TotalFinaElf (55%); Eni (45%) | 2002 |
| Esfandir | | | | NIOC | |
| Forouzan, Esfandiar | Offshore, Persian Gulf | | 40,000 bpd, expected to rise to 109,000 | Petrollran, with BHP Billiton | 2002 |
| Gachsaran | Onshore, located in Khuzestan | | 480,000 bpd, to increase to 600,000 bpd | | |
| Gachsaran | Onshore | 53 bn barrels | | NIOC | |
| Gurreh Taheri | | | | | |
| Hengam | Offshore, Sea of Oman | 800 bn cf of gas and over 400 M barrels of crude oil. | | NIOC, Oman | Started 2002 |
| Karanj-Parsi | | | 250,000 bpd | | |
| Kharg | Offshore, Persian Gulf | | | | |
| Lavan A | Offshore, Persian Gulf | | | NIOC | |
| Marun | Onshore, located in Khuzestan | | 520,000 bpd, to increase to 600,000 bpd | Saipem: 6 rich gas compression plants. | |
| Masjed-I-Suleyman, (MIS) | SW Iran. Iran's first oilfield, discovered 100 years ago. | | 4500 bpd, expected to increase to 20,000 in 3 yrs | Sheer Energy (2002), joint venture with Naftgaran | 2002 |

| | | | | | |
|------------------|------------------------|--------------------------|---|---|------|
| | | | | Engineering Services Co., a unit of NIOC | |
| Pazanan | | | 35,000 bpd | | |
| Rag-e-Safid | | | 180,000 bpd | | |
| Salman | Offshore, Persian Gulf | | 100,000 bpd, to increase to 150,000 bpd | Statoil, NIOC | |
| Siri | Offshore, Persian Gulf | | | | |
| Sirri A | Offshore | | 20,000 bpd | Total, Petronas (one of the first buy-back contracts) | 1998 |
| Sirri E | Offshore | | Expected to reach 120,000 bpd | Total, Petronas | 1999 |
| Soroush/Nowruz | Offshore | 1 Billion Barrels | 255,000 bpd | Shell (14 Nov 1999) | |
| South Caspian | Derricks | | | | |
| Strait of Hormuz | Exploration | | 130,000 bpd | Statoil/NIOC | |
| Yadavaran | Onshore, Khuzestan | 6 Billion barrel reserve | | | |

To conclude, whilst Iran has been able to find alternate sources for generating revenue and income for its oil industry, the lack of American companies effectively reduced the amount of competition other companies around the world had to face, whether they be regional, Islamic or European. This diminished the negotiating powers for Iran thereby generating less appealing terms for the country as it strove to offer better incentives for companies abroad. However, this did not curtail production, as the US measures originally intended.

8.6.8 The financial damage resulting from sanctions

Damage done to the Iranian economy as a result of the sanctions imposed by the US has been caused mainly due to the lack of investment which they have caused. Without sanctions, Iran

would have been able to contract with greater feasibility of success and security, and with better terms. It would also have had the opportunity of financing the projects by itself.

As a result of the sanctions Iran was forced into a few deals that were far from ideal for the country, and was further coerced in funding itself through various sources at a high price because of US manipulation of foreign aid and financing.

The amount of loss incurred by Iran as a result of the sanctions can be calculated by taking as a base the finance charges in excess which Iran had to bear with, in addition to the extra interest charges by it incurred for its loans and foreign debt.

The IOC's expenditure on the development of buy-back projects amount to debt, for Iran bears the risk of all projects and is required to compensate the companies for all investment and additional expenses undergone in the process. Due to sanctions, and with Iran's negotiating powers somewhat restricted, Iran was faced with situation where it found itself offering high rates of return for investment as an incentive to investment. Dropping the originally proposed 10%, it offered on average between 15% to 18% rates of return for many contracts with foreign oil companies. Examples are the South Pars and the Sirri oilfields, both signed with very high rates of return, and close to those demanded by the oil companies themselves.

Were it not for the sanctions, a maximum rate of about 12% to 15% could have been attained, given all other circumstances. Such excessive charges can be used to calculate the cost of such projects to Iran. Recently, the buy-back contract has undergone criticism, and Iran has been compelled to reduce several of these rates. Using a 3% premium, the cost of financial sanctions

on such projects per year amounted to \$266 million. This is the amount that Iran had to pay extra for the \$8.874 million contracts signed by it since 1995.⁵¹⁵

US sanctions undoubtedly negatively impacted the economy, and the NIOC had to strive in order to provide incentives for the negotiation of contracts with other countries. Costs incurred in the process of finding alternatives however, as has been previously mentioned, were offset by surging oil prices, meeting the costs.⁵¹⁶

The imposition of such costs does deter a country's short-term perspectives, economically and even politically speaking, but it does nothing to promote the goals the US originally sought to achieve, such as the change of a political regime, or coercion towards more US-friendly foreign policies. Furthermore, costs incurred by the US itself may weaken the will to continue the imposition of such sanctions.⁵¹⁷

It is thereby contended that the impact made by twenty years of sanctions has not met their target. Iranian foreign policy has not shifted, and conservative clerics and their allies still manage public-sector enterprises within Iran. Undoubtedly, prospects of economic recovery and development have been obstructed, but not halted.⁵¹⁸

8.7 The Reaction of other States to US Sanctions

The US, in expectation that all nations would side with the sanctions and boycott Iran, was soon disappointed. Other states had their own interests and economy to safeguard, and the ratio of their dependency on Iranian oil exports, was on average, higher than US dependency on Iran

⁵¹⁵ Unfortunately, in the absence of information on the exact timing of investments and the details of cash flow it is impossible to calculate the excess charge with a reasonable degree of accuracy

⁵¹⁶ The Iran and Libya Sanctions Act of 1996: Results to Date Jeffrey J. Schott Institute for International Economics

⁵¹⁷ Speeches, Testimony, Papers

The Iran and Libya Sanctions Act of 1996: Results to Date Jeffrey J. Schott Institute for International Economics

⁵¹⁸ Valibeigi, M., 'Law of Unintended Consequences: US Sanctions and Iran's Hardliners'

alone. For instance, in 1994, Germany exported four times as much to Iran rather than curtailing trade, and Italy, France and Japan, each exported twice as much as they had previously. Such countries, like many others, held the belief that sanctions would have little or no effect on coercing Iranian policies or having a lasting impact on Iranian politics or economy, or the society in general.

In 1992 the European Union had officially embarked on its policy for ‘critical dialogue’, thereby assenting to the maintenance and development of economic relations with Iran, whilst maintaining the liberty, amidst diplomatic talks, to criticise its regime and its policies.

It is contended that “The extra-territoriality issue of [the ILSA] has been widely criticised around the world. In particular, the European Union introduced legislation that Europeans shall not comply with ILSA. EU also complained to the world Trade Organisation.”⁵¹⁹

The US was therefore left on its own to enforce its embargo, and in an effort to make things better, Secretary of State Warren Christopher requested that EU companies refuse to take up contracts previously held by US companies in order to effectuate the ban.

The request went unheeded as companies such as France’s Total embarked on a \$600 million deal on an oil contract in relation to Sirri, previously held by Conoco, before the sanctions took effect.

In retaliation, the ILSA was adopted on 11th October. It was proposed by Republican Senator Alfonse D’Amato, Chairman of the US Senate Banking, Housing and Urban Affairs Committee. The bill proposed entailed the penalisation of all foreign persons exporting petroleum, oil or

⁵¹⁹ Takin Manouchehr, Working with Sanctions, Trade Controls & Political Risk 03, Case Study: Iran, Centre for Global Energy Studies

natural gas, or related technology, to Iran, and entered into force in 1996, after Clinton's approval.

The ILSA effectively saw a reduction in the economic relations of the US with Europe and Japan, as the US saw their acts as undermining the ILSA because of their dealings with Iran in opposition to such measures. Japan, for instance, had agreed to talks that would result in the commencement on a massive project for the development of the Azadegan oil fields, which, due to US pressure is currently at a stalemate.

In response to US reaction, Iran has also indicated a willingness to deal in euros rather than dollars for its oil exports in the future.

Following Khatami's election in 1997 as President of the Islamic Republic of Iran, the US government agreed to alleviate a lot of the sanctions burden in order to progressively assist Khatami in reforming Iranian society, and in order to set the stage for easing sanctions at a later date, and for better relations with the US. In line with such a policy sanctions on medicine and food to Iran, Sudan and Libya, by part of the US, was ended on the basis that such sanctions did not inhibit or aid the military capabilities of a nation, or its nuclear programme.⁵²⁰

8.8 Iran's Response to the US Sanctions

Iran has been able to react and respond effectively, to an extent, under the pressure exerted by the sanctions, primarily in adjustment to the length of such sanctions. Regardless of the ILSA coming into force in 1996, Iran has been successful in attracting \$20 billion of investment from nations worldwide for its oil and gas development projects.

⁵²⁰ World Bank News Release No. 2000/352/S (May 2000); 'Waking Up From A Nightmare', *The Banker* (September 1993, pp. 43–48); Senate Hearing, *The Comprehensive Iranian Sanctions Act of 1995* – S. 277 (1995, p. 5).

However, despite effective response, a few oil experts within the country contend that several domestic reforms could increase foreign investment and interest in Iranian oil. For instance, the buy-back contract terms and conditions have been the object of frustration to many foreign investors. Reform of such contracts would effectively increase Iran's power to develop its oil industry. Currently, the Iranian constitution forbids foreign ownership of natural resources. The means used to get around the problem has been the incorporation of buy-back contracts, repaying international companies a share of the output from projects they invest in. Concerns raised of this method of repayment include the fact that repayment often fails to meet the rising project costs. As stated by an energy consultant at Varzi Energy, Iran is its worst enemy,⁵²¹ in this respect. The problem of sanctions could therefore be better dealt with if contracts and methods of repayment, such as the buy-back, were reformed.

Iran relaxed state control over its oil industry, so as to be able to attract foreign investment, allowing for increasing private investment within the industry. Reserves however remain under government control. Moreover, Iran, by signing several important contracts with international oil companies, has obtained foreign investment. Some newspapers report that Iran has secured an estimate of \$4 billion of oil and gas contracts to the country's private sector.

For the attainment of better prices and in order to sell oil in currencies other than the dollar, Iran envisages the launching of the international oil bourse in Kish, at the Persian Gulf. At such a bourse, oil contracts will be traded in rials, euros and other currencies. This will be done in order to boost competition. The success of such an enterprise will depend on the reaction of other countries, and their support. Currently, oil is traded in dollars in the New York Mercantile Exchange and the London International Petroleum Exchange (IPE). Iran's bourse will be in competition with such exchanges, and may be attractive to countries whose interests are not

⁵²¹ Webb, S., Iran Focus. <http://www.iranfocus.com/modules/news/article.php?storyid=9715>

satisfactorily covered by the aforementioned exchanges. If such a bourse is successful, then it will contribute towards the creation of an oil market open all days of the week, around the clock. Iran has also converted a lot of its dollar reserve to euros and other currencies, as well as to gold. Dollar reserves constitute less than 30%, at the moment, but this has not created any problems for Iran in opening letters of credits for imports in foreign banks. Iran has also sold some of its petrochemical exports to other nations until 2009.⁵²²

8.8.1 Political Strategies

Iran, faced with the ILSA, has had many options it could choose, in reacting to such measures. A certain strategic option would be to concentrate on developing technology locally, as necessary for the development of Iran's oil industry, instead of recruiting foreigners in the task. This would not only avoid the primary steps which effectively triggered sanctions, but would create a self-sustaining framework which would invariably lead productive results in the long-run. However such an approach would entail knowledge of the manufacturing and service provision as is entailed in the oil industry.

Alternatively, Iran could start talks with the United States. Such talks could resolve the countries' conflicts, and end the sanctions regime if a settlement is reached or agreed upon. Another possibility would be direct confrontation with the US, and offering incentives, or persuading other countries' firms to act contrary to the US's wishes.

Iran has practiced and exercised all the aforementioned strategies to a degree. However, it has focused on the last strategy of confronting US policy and inducing states' companies to act in breach of it. After the ILSA took effect, many countries including Canada, Australia, Japan, China and members of the European Union voiced concern at the extraterritorial nature of the

⁵²² Torbat, A. E., 'UN Financial Sanctions on Iran: Political Confrontation, Iran's Response to US Threats'

Act in question. The Act's unpopularity further amassed after Iran's economic recovery, following its industrial development, triggered also by the receipt of international aid, amounting to \$30 billion. As a result, Iran amassed a great deal of debt, and many countries felt that the imposition of a harsh sanctions regime would effectively hinder Iran from repaying the debt, and the country would fall into further difficulties, entailing the loss of a substantial amount of money.

In order to motivate other firms further in investing in Iranian oil, the authorities of Iran have launched promotion campaigns for many oil development projects, including calling for a 10% increase in the production capacity within ten years time, and a 30% increase is envisaged in the next 30 years. The government in order to meet such targets have offered many attractive terms, in order to induce investment. Such methods have worked for many companies, who have been substantially motivated to act in breach of the ILSA.

The method of direct confrontation has not only helped Iran in dealing with the sanctions regime, but has also allowed for the growth of local manufacturing and servicing capabilities, with a little foreign assistance. With \$2 billion per annum of parts and services, Iran has embarked in a mission to stimulate and develop the local infrastructure, to meet demands for its oil industry. For instance, Iran has set up many manufacturing companies to produce specialised parts required in the oil generating process such as pipes, gaskets and valves, to be developed locally, or to be adopted in affiliation with foreign corporations. Parts previously acquired from the West have now been replaced with alternative sources, as Iran looks to China and the Eastern Europeans for advice and support.

Iranian efforts at conciliation with the US have been the least effective. Despite Khatami's expounded image of reforming Iranian politics, and the consequent US softening, direct dialogue

with the US is still considered out-of-bounds for many Iranians, and is, likewise, improbable to occur.⁵²³

8.8.2 Foreign Policy Initiatives

In the 1990s, in order to reduce the effects of dual containment, Iran had built up strong relations with the West, and particularly the US, with the result that, by 1994, it had become its dominant purchaser of oil. However Iran also focused on building relations with countries such as Russia, particularly commencing in 1989, after a series of bilateral agreements, one of which aimed to establish joint companies to explore the Caspian Sea and produce oil from the region. The Soviet Union break-up offered further opportunities for Iran to gain trading partners amongst former Soviet Union states. Iran's central location, important for oil transportation through pipelines and swap agreements, has also contributed in facilitating the establishment of trade relations with other countries. Iran also had the opportunity to strengthen partnerships with countries such as India. Iran and India in 1995 launched the India-Iran chamber of commerce, and have established a joint shipping company, as well as securing other deals in relation to other industries.

Relations between Iran and Malaysia have particularly affected the oil industry. Partnering with Total, Malaysia has helped in the development of the two Iranian off-shore gas and oil fields situated in the Persian Gulf. South Africa too, since 1994 has begun to buy Iranian oil, and receives most of its oil from Iran, to date.

⁵²³Estelami, H., 'A Study of Iran's Responses to US Economic Sanctions'

8.9 Case Study on the Iranian Response

In deterring countries from embarking on trade relations with Iran, Washington has used several tools and schemes.

The ILSA, for instance, allowed the federal government to ban the purchase of the offending company's goods and services, issue a loan ceiling of \$10 million by US financial institutions on the offender company, prevent the offending company from acting as the main dealer of US treasure bonds, banning the company from exporting and importing goods to the US, and denying the company licenses as export/importer.

The ILSA has not been largely invoked, and nor has its successor, the Iran Freedom and Support Act (IFSA), save for one occasion. In order to control Total's activities, for having signed a \$2 billion contract with the Iranian authorities for the development of the South Pars natural gas field, the US invoked the Act. However, normally the mere threat of using such an Act suffices in order to deter companies from the completion of contracts with the Tehran authorities. British Petroleum, for instance, declared in January 2005 that politically speaking Iran was not entirely in the best position, since British Petroleum had substantial ties with the United States.⁵²⁴

Trade and investment sanctions have deeply affected the course and nature of the competition for the Iranian oil industry, and business in general. The effects however have been felt more by American companies than others, caused by the practical difficulties of the enforcement of laws beyond the territorial jurisdiction of the state, and the fact that many companies have declared themselves to be immune to such extra-territorial jurisdiction.

A deal was made between the NIOC and Conoco, a subsidiary of the Dupont Corporation, for the development of two offshore oil and gas fields in the Persian Gulf, to the value of \$600 million.

⁵²⁴ Torbat, A.E., op.cit.

This was cancelled by the US government however, in line with US foreign policy, and the ILSA, in particular, attaching criminal liability to trade related conduct with Iran.⁵²⁵ In relation to the Conoco case, as a result of the passing of the ILSA, Conoco found itself obligated to drop out of the contract for the development of the Sirri A and E oil and gas fields. Shortly afterwards, the Executive Order 13059 was passed, establishing another blanket prohibition of all trade and investment by US citizens in Iran.

The ILSA has been objected to by a large number of foreign states. Despite the ILSA, as has been restated many times, Iran has nonetheless managed to attract roughly \$30 billion in foreign investment for its oil and gas industry.

The European Union expressed its formal opposition to the ILSA on 22 November 1996 through the passing of Resolution 2271, declaring EU companies of being capable of non-compliance with the ILSA. Although no ILSA sanctions have been imposed as yet, the mere threat has been enough to deter several companies from investing in Iran, or entering in trade relations with Iran. Such was notable in the behaviour of the Indonesian firm, Bakrie, from the deal entailing development of the Balal oilfield.

The TotalFinaElf, Gazprom and Petronas consortium, in May 1998, working on the development of the South Pars gas field, obtained a waiver under Section 9(c) of the ILSA by the US. Secretary of State, Albright, stated that such a waiver was allowed as the project encouraged cooperation between nations such as the US, the EU and Russia.

Against Italian Eni, who settled a \$3.8 billion deal for the development of the South Pars oil field, the US announced its plan to consider sanctions against Eni. Despite this however, and the

⁵²⁵ Estelami, *op cit.*

ILSA, Italy signed five half-year buy-back deals to develop the Darkhoven oilfield, worth nearly \$1 billion. Further, companies such as BHP Billiton Ltd were held to have been considering taking part in the development of the Foroozan-Esfandiar oilfield in May 2002, although they effectively did not conclude such a deal. The US has also announced its intention to review the Canadian company Sheer Energy's contract with Iran in order to see whether the company acted in breach of ILSA. However, no action has yet been taken on such a point.

In 1995, Total and Petronas replaced Conoco, in undertaking the Sirri A and E oil and gas field project. Total was held to not be in violation of the ILSA, despite its investment being worth a grand total of \$600 million. Petronas, acquiring 30% of the Sirri deal in 1996, refused to back off, despite US protest.

In 2000, the US Treasury Department decided to investigate Conoco's role regarding transactions with the NIOC, and the Azadegan oilfield deal. Conoco denied acting in breach of the ILSA, although it remains interested in the development of Azadegan. Talks ensued about development of the oilfield with Japan. Most recently, Iran has begun negotiation on the Caspian Sea and oil swap transactions, and in 2004, Lukoil and PetroKhazakstan made bids for the exploration of Iranian oil blocks.⁵²⁶

US economic policy has limited Iranian access to financing, technology and supplies from the West. It has also triggered certain economic mismanagement and difficulties, such as high inflation and increasing unemployment rates. However, despite all these it has not managed to fulfil its role of halting international investment and trading in Iran's oil industry, which is continuing to develop. Effectively the sanctions have cut American firms out of the race, whilst

⁵²⁶ Global Energy Sanctions, July 2004 [<http://www.eia.doe.gov/emeu/cabs/sanction.html>]

many other firms from Europe and Japanese firms, although acting in violation of the ILSA, go unchallenged.⁵²⁷

Total, the largest oil investor in Iran, and the dominant player in the South Pars field project, failed to recognize US legislation, with the alleged backing of the French and other European governments. Total spokesman have stated repeatedly that the company will not back out of the \$600 million agreement signed in 1995 because of US law. They fail to recognize that US jurisdiction may be exercised extraterritorially in this respect. However, other companies, such as BG Plc and Royal Dutch/Shell Group, have been more respectful towards the sanctions, declining to develop gas fields unless the sanctions are lifted.

Petronas on the other hand has not been stopped by the sanctions and has invested substantial money in Iran. Recently, it added to its investment a 30% stake in offshore oil fields in the vicinity of Sirri. Petronas is willing to expand its global business, and businessmen affiliated with the company stated that American sanctions were not an object of fear for them.⁵²⁸

Halliburton, a company formerly headed by Mr. Cheney, has been involved with investments in Iran, and recently, has been the topic of some debate in the US, especially considering the Bush administration's policies. In 2004, China and Iran inked a Chinese investment deal, which, if goes as predicted, could amount to \$100 billion. This too, has been done in flagrant violation of the ILSA, since it crosses the \$20 million threshold limit for investment in Iran's oil and gas sectors. Iranian officials hope that the securing of this deal will be pivotal, as an example to others.

Recently, Iran is embarking on plans to initiate investment funds abroad in order to finance its South Pars gas field project, and as a reaction to US sanctions. In retaliation to the sanctions,

⁵²⁷ Estelami, H., 'A Study of Iran's Responses to US Economic Sanctions'

⁵²⁸ Journal Record, The (Oklahoma City), Sep 30, 1997 by Edward Roussel Bloomberg News
http://findarticles.com/p/articles/mi_qn4182/is_19970930/ai_n10112037

Torkan, the former Iranian defence minister, commenting on the increasing US pressure, has said that funds would be based in Bahrain or Dubai, for investment. This proposal however as yet awaits government approval, but Torkan seemed confident that the fund would obtain it in not more than a month. The derived cash would be allocated to the field, for its development phases, and would ensure reduced government spending on it from the public purse.

Such projects come in light of US sanctions on two Iranian banks, and US pressure on foreign banks, which has had the effect of reducing foreign investment in Iran.

Consequently, many of Iran's previous investors, such as Royal Dutch Shell and Total, have hinted that Iranian politics could come in the way of hindering their new investment plans. Further, Societe General withdrew from two of its stages, 17 and 18, of the South Pars gas field, which Torkan alleges is due to US influence. In relation to Societe General's withdrawal, the government has had to spend \$720 million from oil reserves for the project, but that is not enough to meet its \$5 billion cost.

In relation to the present scheme, investors would receive a guarantee minimum rate of return of 8% by the NIOC, and a maximum of 15.9%. The time frame stipulated for the return is as yet unknown, however. Currently, negotiations are ongoing with Petropars and Eni for the buy-back contract dealing with development of South Pars for the phases 19-21.

A deal of \$25 billion, with the China National Offshore Oil Corporation is expected to be signed also, by the end of August 2007. Relations with China on this matter progress steadily, and, as Torkan states, all that is required is finalisation.

Buy-backs are standard development contracts in Iran, where contributing funds towards the exploitation of a deposit is subsequently compensated through a portion of the output. Torkan said a \$25 billion deal with China National Offshore Oil Corp (CNOOC), parent of Hong Kong

and New York-listed CNOOC Limited, would be signed by the end of August. Prospects for the development of South Pars have not been hindered by US sanctions; the fulfilment of its full production potential, a gargantuan 700 million meters cubed a day, will take some time. The first five phases of the process have been completed, and operations for phases 6 to 8, to be dealt with by Statoil, is going to commence shortly, followed by Korea's LG who will take care of the next few phases.

The last phases for the development project still need to be negotiated, but Shell and Repsol have indicated interest.⁵²⁹

The Iranian Deputy Oil Minister for International Affairs, Hosseini, has given some indication of the policy required to better retaliate to the sanctions imposed by the US, in relation to Iran's oil sector, and the oil ministry's future contracts. It was stipulated that no clear solution is available to the US-Iran situation, but that in relation to sanctions, the US has suffered also, as a result of the sanctions. Hosseini contends that the situation is not altogether bad, in view of international demand for the security of the oil market, and in view of the fact that US actions have led to many countries aligning with Iran, as protest to US measures. Hosseini further claims that Iran has a fixed economic programme to curtail the effect of sanctions; in order to meet industrial demands and to gain the requisite capital, non-American companies have been, and are being sought. Iranian policy is to expand relations, particularly within Europe. Hosseini, in recalling the London Seminar in 1999, remembers the reaction of British officials worried about losing opportunities of investing in Iran's oilfields. In relation to the US-Engage Union, comprised of 600 companies, banks and instates within the US, active in sanctioning Iranian oil, it is contended that they too are undergoing losses and are suffering.

⁵²⁹Reuters - 28 May, 2007, Iran eyes new fund to avoid sanctions
[http://www.gulfinthemedia.com/index.php?id=314320&news_type=Economy&lang=en&]

In terms of Iran's future oil policies, it is thought that a lot depends on the economic policies that will be adopted by the new Parliament, but that policies should be supportive to the oil industry in order to enhance its development.⁵³⁰

8.10 Conclusion

Sanctions are useful for the attainment of short-term objectives, such as the release of US hostages in Iran in 1981, but it fails to fulfil its long-term objectives when cooperation as between other nations is lacking. Successful cases of sanctions, it is contended, are rare, particularly in light of the globalization phenomenon, allowing target countries to find alternate suppliers and consumers, and capital markets. US sanctions have declined in their effectiveness by the decade. In the 1960s for instance, sanctions contributed to the fulfilment of US objectives in relation to its foreign policy goals in less than 20% of the time.

US sanctions have induced Iran to react and develop in a number of ways. Firstly, it has encouraged Iran to explore new trade partners and establish contact with them, diversifying Iranian trade. Prior to 1974, it will be noted that only seven countries accounted for almost 70% of all of Iran's trade; two decades later, this number had doubled to fourteen countries, with Iran's previous top seven partners in trade constituting only 50% of its exports and imports.

The trade and investment sanctions have affected competition for the Iranian market. However, the effects of changing competition have been felt also by American companies, which, whilst formerly retaining a central position in investing in Iran, now were found to be excluded completely from the nation's market. The practical difficulties of enforcing the ILSA, as it so does happen, with any extraterritorial measure, also accounts for problems facing American

⁵³⁰ Future of Iran's Oil, an interview with Mr. Seyyed Mehdi Hosseini, the then Deputy Oil Minister for International Affairs [<http://www.iranexportsmagazine.com/Archive/mag%2063/interview63.htm>]

companies as has been discussed within the body of this chapter. Companies such as Boeing, Conoco and BP America are excellent examples of those American companies which have been negatively affected by the imposition of the sanctions.

The US economic policy has effectively limited Iran's access to technology, aid, financing and supplies. At times it has forced Iran to accept impracticable deals, and has vastly reduced its negotiating powers, particularly in the context of buy-back contracts. It has contributed therefore, to the economic hardships of a country already economically instable.

The sanctions have a tendency to hurt the Iranian people while leaving the ruling mullahs relatively unaffected due to them and their families having amassed a vast amount of wealth in personal bank accounts outside of Iran.⁵³¹

Nonetheless, the sanctions fall short of their true objective, of bringing to a complete halt all trade and investment in relation to Iran's gas and oil industry, as envisaged by the US measures.⁵³² Iran has looked elsewhere for trade partners, and has found them. Despite harsher deals and harsher conditions when rescheduling debts, countries have been willing to trade and invest in Iran, and Iran has managed to continue to restructure its oil industry, both locally, and globally, despite the imposition of the sanctions. On the other hand, American companies have lost a chance to compete in Iranian markets, replaced by their Asian or European counterparts.⁵³³

The effect of sanctions, as one of the many factors influencing the attractiveness of Iranian oil contracts, will be juxtaposed and analysed within the concluding Chapter.

⁵³¹ For accumulated wealth of the Mullahs: 'Millionaire Mullahs', by Paul Klebnikov, Forbes magazine (21 July, 2003, pp. 56–60). A detailed list of their bank balances abroad has been reprinted in Mardom-e Khavar-e Mianeh ('The Middle East People', 21 March, 1999, pp. 143–74), Alfred Hemingway Publishing, Los Angeles, CA.

⁵³² Askari, H., J. Forrer, H. Teegen and J. Yang (2001), 'US Economic Sanctions: Lessons from the Iranian Experience', Business Economics, XXXVI, 3, 7–19.

⁵³³ Estelami, *supra* footnote 5.

Chapter 9: The Superiority of an Evolutionary or a Revolutionary Approach

Iran's fulfilment of its main goal to perform various macro-economic plans intended to revitalise the country's economic and social life often clashes with economic realities, such as the high population growth, an extensive benefits system and a growing retired population. In order to successfully go through with the reforms, significant budgetary allocations are required that can only be achieved through formation of oil contracts with foreign parties. However, due to Constitutional limitations on oil transactions, imposed after the 1979 Revolution, only buy-back contracts are permitted to circumvent the legal prohibitions. Consequently, in order to analyse and improve the attractiveness of buy-back licensing agreements, it is necessary to examine this model from a historical and economic perspective, as well as with reference to its implementation, subsequently extrapolating suggested improvements.

9.1 Effect of Historical Factors on the Nature of Buy-Back

An examination of the present and future of a complex financing mechanism like the buy-back is impossible without first understanding the motivation behind it, therefore permitting one to deduce how the same socio-economic system will react to attempts to reform, based on previous experience. Foreign investors are sometimes confused by the severe restrictions on oil transactions imposed by the Constitution through the buy-back, insisted upon by the Iranian authorities despite the possible economic advantages of utilising a different contractual arrangement. However, a careful analysis of the historical context of the Iranian oil industry will show that the fear of foreign exploitation of Iranian national wealth is not merely an irrational one, but is well founded upon historical precedent of similar abuses. Without studying the historical reasons for Iran's adoption of the restrictive current model, it is impossible to fully understand either the current difficulties faced in the course of oil transactions or predict the

viability of utilising a different contractual model in the context of public perception and government policy.

A critical component of a historical understanding of buy-back is analysis of the earliest period of oil production in Iran, when the wariness regarding oil transactions with foreign parties was born amidst massive exploitation of Iranian national treasure. The concessions made to foreign powers during this period were characterised by their breadth of scope and were often acquired through the application of direct political pressure from one of world's leaders, with whom Iran could not compete either economically or politically, forcing Iran to accept terms that included tax breaks, unbalanced arbitration, uneven profit sharing and others. This trend has begun with the early Reuter and Hotz concessions, which were heavily biased in favour of the foreign party, by not guaranteeing sufficient technological exchange and profit for Iran, therefore leading to instability in the industry and the premature cancellation of these oil contracts.

Whereas the theme for the early concessions was exploitation through commerce, in the 20th century, on the other hand, the Iranian grievances centred increasingly around foreign diplomatic and political involvement, in addition to the acquisition of unbalanced concessions. It becomes clear from these political interactions that Iran was perceived only as a pawn in the political struggle of the world's powers; an attitude that was clear to both the Iranian politicians and its people, and consequently can be seen as a major contributing factor to the harsh Iranian attitude on foreign intervention today.

The stage at which Iranian dissatisfaction regarding generally unfair concessions turned into opposition to the specific terms of these concessions occurred when Iranians began to realise the inadequacy of the royalties from the AIOC, especially in comparison to its profits of 150%. As well as commercial reasons for Iranian concerns, political grievances also existed; as the reason

why more profitable and balanced contracts could not be signed was that Iran had to gingerly sidestep political repercussions of signing agreements with some countries. Indeed, the situation is reminiscent of the present whereby Iran must be careful to not engage in extensive commercial relations with one major power while ignoring the others, even if other options are more profitable.

A historical analysis of oil transactions also shows that many social and political upheavals are related to the question of the distribution of the direct and indirect economic benefits of the oil industry between its foreign owners and the Iranian economy. Consequently, such an analysis shows that the maintenance of the regime and politics generally are closely tied to oil and one tends to change when the other is radically reformed. Such an interconnected relationship elucidates the controversial nature of oil decisions and the unwillingness to change, as the government's fate is often tied to the status of oil transactions. Consequently, the vulnerability of the regime to oil difficulties makes it unlikely that risks will be taken with introduction of new contractual model, but does make the compromise solution of integrating elements from other models in order to enhance the current licensing agreement's appeal more probable, as the government strives to enhance oil profits, which form the basis of its budget, military and therefore national security.

Historical precedent confirms the dangerously disruptive effect of oil difficulties; for instance two of the most significant social and economic events in recent Iranian history, the 1951 Nationalisation and the Islamic Revolution, both occurred due to dissent over oil contracts. Furthermore, this pattern suggests that any radical change in the framework of oil, for instance the introduction of a new financing model, especially if perceived as pro-Western, will lead to another serious upheaval.

9.2 Nature of Buy-Back and Relevant Statutory Limitations

As the result of historical analysis, it is clear that precedents exist that reasonably give rise to caution when dealing with foreign involvement in the oil industry, as manifested in the Foreign Investment Law (FIPPA), the Petroleum Law and the Constitution. Further elements of buy-back as it can be seen today may also be attributed to its historic origins. For instance, the replacement of cash returns within the scheme with permission for the investor to sell the output of production is motivated by a desire to ensure the quality and constant supply of oil. Moreover, the terms of buy-back contracts are affected by Iran's desire to eventually take on the responsibility of developing domestic oil fields on its own; therefore resulting in provisions requiring minimum employment of Iranian nationals and the abandonment of equipment once the buy-back runs out. In its pursuit of the goal of achieving independence of excessive foreign involvement, a number of abovementioned statutes have been passed which shape and restrict the attractiveness of Iranian contracts. Moreover, the flawed nature of these statutes has been analysed, especially that of FIPPA's contradictions with Constitutional limitations, resulting in a lack of legal certainty for investors and therefore lowering contracts' appeal. Having outlined the legal limitations and their various drawbacks, it is logical to comparatively examine alternative systems which may successfully replace the buy-back without infringing on these legal limitations.

9.3 Alternatives Schemes and Their Compatibility with Iranian Law

As has been already shown, restrictive buy-back agreements are perhaps an inevitable result of Iran's commercial victimisation by foreign oil firms in the 19th and 20th centuries. However, as shown by the failure of Iran's oil development to reach the domestic Ministry's expansion targets, interest in Iranian oil fields is hampered by the oil companies' perception that buy-back

is significantly inferior to other models, resulting in a comparatively small number of contracts having been inked in the recent years. Taking into account the fact that in the past decade Iran has offered some of the best oil projects for international tender, the global oil industry's response has been very limited. Some academics argue that, ironically, it was the high price of oil in recent years that prohibits progress and reform in oil transactions, by improving profits and hiding the current system's flaws. It is argued, however, that even if the prices fell and the pressure for reform increased, it should be the buy-back Licensing Agreement rather than an alternative scheme that governs oil transactions in Iran, due to both Constitutional restraints on radical reform and the possibility of gradually altering buy-back so as to resemble a more globally used framework.

The most commonly proposed alternative, Production Sharing Agreement, has the advantage of being a long-term agreement, allowing states to forecast future growth in the extraction of oil, gas and other useful minerals, enabling them to accurately plan their future budget. Whereas conventional tax is complicated to calculate and difficult to collect, the PSA allows the state to receive a certain fixed part of the extracted product, simplifying the process. PSAs are also desirable for investors, as it protects them from fluctuations in the tax regime of a country.

Nonetheless, by its very nature PSA is contrary to the prohibition against such involvement in the Constitution and therefore is not a viable alternative to the buy-back. According to Dr Hossein Afarideh,⁵³⁴ the Majles Energy Commission Chairman, several comparative advantages of PSAs are, in reality, not existent when compared to buy-back, specifically the relative lack of risks in PSAs; as Iranian buy-backs allegedly always result in successful exploitation of large deposits. Furthermore, the added advantages of PSAs such as accurate budget planning may and,

⁵³⁴ Dr. Afarideh, with a doctoral degree in atomic energy has been employed in various academic positions, including within Iran's Atomic Energy Organisation.

currently, are, being achieved through reforms to buy-back such as cutting risks to the foreign party in case of unexpected expenses, and later cost estimation dates.

In addition to avenues of reform based on entirely different contractual frameworks, the option to integrate further elements from the International equivalent of buy-back, namely the UN-proposed Model contract. As has been shown through extensive analysis above, the Iranian model goes beyond simply interpreting the International model's provisions to fit local circumstances, but also restricts the rights of investors excessively through inclusion of novel provisions. Among such controversial provisions are excessive requirements for initiating arbitration as well as various other clauses that are not present or hinted at in the International contract and which severely limit the attractiveness of Iranian buy-back. It is noteworthy that most of these provisions are of a procedural nature and eliminating them would not contravene the substantive limitations imposed by the Constitution on ownership of oil fields. Consequently, all that is required to add a significant element of attractiveness to the existing scheme are modifications to procedural aspects of buy-back in order to make its structure more proximate to that of the internationally recognised UN model. These changes may also be made without altering the model extensively and infringing the Constitutional limitations, while also maintaining the buy-back model's essential features which are in accordance with the Iranian government's stance.

9.4 Potential for Statutory Change

In reference to the possibility of changing the Constitution so as to no longer impose limitations on oil transactions, it must be noted that this process has essentially no chance of succeeding in the present geopolitical environment; and very little chance of success even at the best of times. This is due to the arduous and complex process required to change the Constitution, as it is the

basis of all other laws as well as the Islamic Republic itself. The steps that must be taken in order to alter the Constitution are expressly listed in Article 177 of the Constitution and include permission by the Supreme Leader, heads of the government branches, various judiciary, religious and academic officials, as well as the approval of a country-wide referendum. As a significant proportion of these enabling authorities are conservative in nature, it is therefore very unlikely that the oil regime would be liberalised, especially at a time when Iran is at a diplomatic standoff with the West. Moreover, as previous radical reforms aimed at limiting foreign involvement in Iranian oil stemmed from the public, it is unlikely that such a pro-foreign approach would gather sufficient support from the public in order for the referendum to be successful. Therefore, there is little possibility of an alternative, currently non-Constitutional oil scheme being utilised, requiring alterations to the buy-back model itself to be made in order to improve the attractiveness of investment in Iranian oil.

9.5 Problematic Provisions and Suggested Reforms

The necessity for some change, whether revolutionary or evolutionary, is nonetheless evident as both foreign and domestic participants in oil contracts voice their grievances with the current scheme. Consequently, whether to satisfy the perceived need for enhanced income for the public as advocated by the domestic parties, or to ease the costs and efforts of oil fields' exploitation, as argued by the foreign companies, alterations to the current buy-back Licensing Agreement must be proposed after an analysis of the current concerns from both perspectives.

Perhaps the most often mentioned concern is the short buy-back duration. As the result of the domestic party's desire to limit its temporal obligations, so as to avoid the public perception of being overly favourable to foreign companies, the contracts are of a shorter length than an extensive operation such as oil production requires, only about 7-10 years, with an additional 5

years as a designated 'investment recovery period'. This, in effect, discourages close involvement and special care by the foreign participants, who are fully aware of their departure date from the project and therefore have little reason to use their technical expertise in order to extend the life of the project.

However, the January 2004 decision to increase the maximum contract length from 5-7 years to a maximum of 25 and permit IOC involvement following the hand-off to NIOC, may boost attractiveness to foreign investors as they partially address some of the investors' main concerns without introducing the legal and commercial chaos that might stem from a rapid and drastic change of the contracts' structure and legal basis. These reforms were confirmed in 2006 when the NIOC issued 24 international tenders for fields with the addition of longer contract terms being available so as to increase recovery rates. It is of especial note that an extension of the time frame will not contravene existing legislature or Constitutional law, therefore not creating the same political and legal problem as the use of an alternative scheme would.

A concern related to the short contract duration issue, and one that can also be remedied with relative ease is that the agreed upon limit on the amount of oil lifted will be broken prior before the IOC is fully remunerated, especially in view of recent fluctuations in oil prices. One means of remedying this issue without causing disruption to the existing system is to include 'carry over' provisions. Such provisions would permit the foreign party to acquire a larger quantity of oil within a specified time frame if the provisional amount was not sufficient; having the effect of decreasing the amount lifted in the period following the increased production. Such measures can significantly decrease the perceived risks associated with unpredictable fluctuations in price, especially at a time when prices may either peak or drop rapidly due to conflict in oil-producing regions.

In relation to the substance of the buy-back itself and the associated risks, an additional dissuading factor for commercial involvement in oil fields is the possibility that the project costs may be elevated in comparison to original estimates, which are currently made very early in the negotiation process, forcing the IOC to pay the difference, resulting in additional risk while the returns decrease. Even factors beyond the IOC's control, such as an unpredictable drop in oil prices, can result in grievous financial losses as the foreign company would be obligated to make up for the costs and agreed return by using a limited amount of oil. The Model buy-back contract fails to account for such commercial contingencies, therefore not allowing for a standardised resolution procedure which would inspire confidence in foreign participants

In response, a new version of the contract was offered by the government whereby Iran will have a closer relationship with the foreign companies during the implementation stage of the project, including participation in calculation of expenses. Vitally, the agreement stipulates that in the contingency that the required machinery and equipment is costlier than predicted in the contract, the domestic party will help compensate for the difference. Even such technical alterations may amount to greatly increased incentives for involvement in the Iranian energy market, such as the proposed innovation of determining the capital budget at a later stage of the project than is currently the practice, therefore permitting one of the most presently dangerous aspects of buy-back contracts to be bypassed, inaccurate estimates of costs for which the contractor would then be liable. Indeed, even the traditionally uneven balance of the bargaining and arbitration power within buy-back contracts is about to be altered through the inclusion of 'get out' clauses permitting contract termination in the case of sanctions.

There is one shared concern regarding buy-back amongst both domestic authorities and oil companies, namely the lack of incentives for improved performance and output of oil fields. As buy-back contracts involve a fixed rate of return for the foreign party and therefore profits are

constant regardless of extra oil output, little incentive exists for the foreign company to continue applying its full technological efforts and resources to enhance production, due to the practice of the IOC acquiring its compensation share of the production from the peak period and then not fully resisting the decline of the field's output. Iranian oil officials propose several ways in which to provide contractually agreed upon reward bonuses for foreign contractors whose fields exceed expectations, therefore ensuring the presence of a motivator for enhancing their performance even after they have acquired their core compensation quantity from the output.

Such terms are atypical for a buy-back contract and clearly indicate the integrative nature of these reforms, which borrow from other successful models not allowed per say by the Constitution. Moreover, Ministry officials suggested that companies be permitted to consult during the production processes, so as to acquire experience in running and consulting on such projects, creating an incentive for enhanced cooperation. An additional benefit of this reform in the long term is the improvement of field efficiency due to the ability of these consultants to offer proposals to the NIOC with practical experience at hand. Nonetheless it remains to be seen whether such measures will remain purely cosmetic or if they help address the seemingly unchangeable limit on the length of the contracts. It is probable that longer and more intense involvement of the foreign parties with the oil fields, even past the actual duration of the contract, may discourage the tactic of taking large amounts of oil for compensation at the peak of the production, so as to shorten the capital turnover, but at the risk of damaging the field.

9.6 The Need for Administrative Reforms

In addition to substantive issues which affect the attractiveness of buy-back by making the contract itself riskier, there are further issues of efficiency and expanses arising out of the overly bureaucratic system, with a negotiation system that is not fine-tuned for such large transactions.

Since the 1979 Revolution, a redundant bureaucratic system has been built around the oil industry, with both the Ministry of Oil and the National Iranian Oil Company duplicating one another's work while lacking accountability and transparency, and therefore complicating the legality and efficiency of dealings conducted with these structures.

To corroborate this assertion, one may note a recent report by FACTS Inc, which questions Iran's capability to increase production capacity and blames the fundamental weakness of the Iranian system for acquiring investment, saying "there is no integrated approach and each group is negotiating on their own. Who wins is the decision of the Minister himself."⁵³⁵ Indeed, Dr. Mina notes that even the structure of these authorities is not clear, as over a hundred companies affiliated with the Oil Ministry and NIOC have been created since the revolution, making dealings with the authorities cryptic and difficult.

A simple yet effective solution, which will not only save money due to legal costs for the foreign investors but also decrease the amount of tax expenditure required, is to separate the Oil Ministry from The National Oil, Gas And Petrochemical Companies. Such a separation would remove the need for the Ministry to combine the functions of an operational governing body for specific field contracts with the more general task of policy making, therefore resulting in less paperwork, bureaucracy and quicker negotiations; an important factor indeed in an industry where circumstance and prices can change very rapidly. Importantly, such administrative reform will not clash with the Constitution or existing regulatory legislation and therefore can be quite straightforward to make.

Another issue of importance relating to the negotiating and contract-signing process is the difficulty for the NIOC in dealing with non-standardised tender bids. The problem occurs due to

⁵³⁵ Nasiri, Ghorban. *Middle East Economic Survey*. The Need to Reconstruct Iran's Petroleum Industry. [<http://www.mees.com/postedarticles/oped/v48n24-5OD01.htm>]

oil firms not agreeing with the standard terms suggested by NIOC and therefore submitting bids which differ not only in price, as is the purpose of this process, but also in terms, therefore requiring individual consideration and lengthening the bureaucratic process. A solution which would not waste the NIOC's time while also resulting in standardised submissions would be to require all the bidders to confer together and decide on 'lowest common denominator' terms which would be acceptable to them. The joint proposal can then be submitted for approval to NIOC, which can proceed with the tender based on those terms or request revision from the unified consultative body of the firms, rather than negotiating with each participant, resulting in time and cost savings.

9.7 Issues of Attractiveness and Effect of Economic Sanctions

In view of a number of upcoming events which will inevitably increase the competition within the oil industry, the probability of successful reform within the Iranian contractual framework is decreasing as time goes by.

The addition of a limited risk-reward element under a revision to the buy-back contract failed to result in the torrent of outside funding that Iran requires. As a result, most buy-back projects in the past few years have gone to local state-owned companies such as Petropars and Petroiran Development Company (Pedco), which defeats the objective of attracting foreign investment into the country.

Further attempts to accelerate the signing of contracts through the offering of a limited risk-reward element to standard buy-back did not have the effect of opening the floodgates of foreign investment, instead local state-owned companies such as Petropars have received significant contracts. Such developments go against the policy goal of bringing in as much foreign investment as possible so as to support the various ambitious social programmes.

Moreover, the opening up of Libyan oil export sector and the potential increase in Iraq's oil output as the result of reconstruction will create extensive business alternatives to investors interested in Iranian oil. The current global level of conflict and tension, as well as instability in the Middle East, may result in rapid price fluctuations which Iran could take advantage of if alterations to the buy-back are sufficiently rapid in order to open further fields through foreign investment before such fluctuations occur.

Within this commercially tense context, an additional element of pressure are the current US sanctions as well as potential sanctions arising out of the current diplomatic disagreement with Iran. The ILSA of 1996 has already somewhat decreased the attractiveness of Iran's oilfields, despite continuing but not frequent signing of buy-backs. Despite the influence of US sanctions, several European and Asian companies have involved themselves in Iranian projects. A thorough examination of the issue conducted previously reveals that the most dissuasive factors in the current political environment are internal rather than external; with foreign investors refraining from investing in Iran due to its policies and internal politics. Therefore, the US is unlikely to achieve its goal of curtailing investment for ten years in order for a significant effect on the Iranian economy to occur, especially in view of the rise in oil production since 1996, when sanctions were already in effect. However, it is impossible to state how future sanctions will affect the Iranian oil industry as their severity and extent is unknown, leaving the possibility of a strong detrimental effect open.

Therefore, the status quo of slow but constant buy-back signing cannot be depended on to persist. There are several reasons why companies currently persist in involving themselves in Iranian buy-back, despite a complete lack of support for buy-back contracts. The first reason is the continuing hope for significant changes to be made to the oil framework by the government,

therefore putting the companies already involved in the country in a more advantageous position than newcomers would be in. The second reason is the high level of competition for such projects; therefore forcing the signing of contracts at unsatisfactory terms in order to avoid a rival company from signing the said agreement. However, the changing circumstances in the form of the opening markets of Iraq and Libya may soon increase the supply of available projects, thereby decreasing the competition for the less commercially attractive Iranian fields. Consequently, reforms to the buy-back system must begin, in earnest, immediately so as to beat this historical development.

9.8 Methods of Redressing Foreign and Domestic Grievances

Buy-back in its current form is vulnerable to competition from other contract schemes in nearby oil producers, therefore requiring serious alterations in order to survive as a viable alternative. Having reviewed the numerous grievances from both foreign and domestic participants, a number of suggestions can be offered in order to maximise efficiency and profit while minimising bureaucracy and expenses, all the while not defying the Constitution as the alternative oil frameworks could. Following an integrative approach, namely borrowing the best elements of alternative frameworks while maintaining the legality of the scheme by maintaining the title of 'buy-back', several suggestions regarding the substantive aspects of such agreements are possible.

Firstly, one of PSA's greatest advantages is its long duration, providing a long term, stable profit for the host country while also adding commercial and legal predictability for the foreign party. Having recognised this aspect of buy-back as one of its greatest flaws, the Ministry of Oil has been proposing a lengthening of certain oil contracts up to 25 years, from the current, overly short 5-7 duration. While commendable, such contract length still would not match that of a

PSA, potentially driving investors to participate in oil operations in alternative locations, particularly as the Iraqi oil fields are expected to become commercially viable in the near future. Consequently, it is suggested that two options exist to make buy-back equally competitive. The first is to simply increase its length to match that of PSAs; however, an issue may arise in that even though such increases are not unconstitutional, they may result in political discomfort for the regime due to a perception of excessive leniency. A second solution that is more likely to satisfy both sides is a contractual provision to be included in the standard Model contract, whereby the contract will be renewed automatically if specified, higher-than-expected output figures are met. This has the dual advantage of providing the oil companies with a contractual guarantee of long-term involvement while also resolving the domestic side's grievance of there being no incentive for the foreign firm to enhance oil production. In order to avoid the pitfall of inaccurate early assessments of production targets, they may be updated at specified points in the development process and the assessment of enhanced production can be based on these updated figures.

In the light of the above factors, it therefore becomes clear that the interests of both parties to energy negotiations, that of utilising national reserves in a maximally efficient manner, and that of maximising profit, may be achieved through continuing and expanding the current reform trend without the need for social and political upheaval that would inevitably result from the adoption of an unconstitutional, non-buy-back model, while the annulment of these legal limitations is practically impossible. Although adopting an alternative oil framework outright may be easier commercially, such ease does not spread to the political realities; in a country which has, in the past 50 years, twice annulled all foreign contracts, drastic replacement of the oil framework is likely to result in a commercially devastating annulment once more, thereby delivering a possibly fatal blow to investor confidence. The only remaining option for Iran is

therefore to maintain the pretence of obedience to the Constitution's limitations while progressively integrating elements from alternative contractual frameworks, which foreign investors find more appealing and trustworthy.

It is noteworthy that not all newly introduced schemes such as the buy-back were immediately popular with oil companies, with PSA's introduction in the 1960s, for instance, being very coldly met by the large oil companies. As such contracts eventually became the hallmark of the oil industry, there is realistic hope that through improvement of its terms, buy-back may also become an attractive alternative to the more traditional agreements.

9.9 Areas of Further Study

Although it was one of the goals of this work to offer a holistic analysis of issues related to buy-back, no single such study can adequately cover the number of social, economic, historical and political issues influencing this type of financing agreement. If further study was to be undertaken, however, a number of issues could be focused on in order to yield sound and informative results. First and foremost, if such a study was to be undertaken in the future, the issue of the geopolitical and diplomatic situation and its effect on Iran should be examined; namely how the current international standoff and any subsequent economic or political measures would affect the viability and attractiveness of foreign investment generally and buy-back in particular. However, such an examination is currently not possible as the relevant events have not yet taken place, although two UN Security Council resolutions have already been passed in condemnation of Iran's recent actions. Secondly, a further fruitful issue to examine is the effect that the changing political attitudes in Iran may have on the survival of the buy-back scheme. As buy-back is heavily dependent on continued political support, being a scheme motivated by political considerations, significant changes in the political stance of the government or within the government itself may significantly liberalise it or restrict it further.

Among such potential events whose effect should be examined are the 2008 elections of the Majles and the 2009 Presidential election, either of which could result in a significant change in Iran's stance on oil contracts. The political and economic ramifications of these events are well worth an additional study. Thirdly, the impact of possible stabilisation of Iraq on the regional and global oil market, as well as on the competitiveness of Iranian oil contracts must be examined further when, and if, such stabilisation occurs. Considering the potential size of Iraqi oil reserves and the effect of such an influx of oil production on prices, it is reasonable to predict that Iranian oil industry may find itself struggling to remain profitable in the context of more attractive, non-buy back schemes offered by Iraq. The economic effect of such supply/demand changes in the region must be examined in detail and corresponding alterations in buy-back must be suggested in order to maintain the viability of the industry. All in all, the topic of oil transactions is one of extensive complexity as it requires an understanding of the political, economic and diplomatic context. Therefore, despite this study providing an objective and detailed analysis of the pertinent legal, historical and political issues, numerous other avenues of research remain open.

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Appendix

1. Model International Buy-back Contract

Buy-back contract

Between

| | |
|--|--------------------------------------|
| X (The individual's name or identity of company) | Address of office/Town/Country(Land) |
| Y (The individual's name or identity of company) | Address of office/Town/Country(Land) |

Whereas

Under a Primary Contract dated _____ (hereinafter the "Primary Contract"⁵³⁶) and the Technical Assistance Contract dated _____ (hereinafter the "technical assistance contract"), X⁵³⁷ has sold to Y, and Y⁵³⁸ has purchased from X, under the terms and conditions set forth in the primary contract and the technical assistance contract, the machinery and equipment and patents and know-how and technical assistance specified therein (hereinafter "the equipment technology"), to manufacture _____ (hereinafter "the products"⁵³⁹) in Y-land.

By way of buy-back, and under the terms and conditions set forth in this contract, Y agrees to sell to X, and X agrees to purchase from Y, products as specified herein.

Now, therefore, the parties to this contract agree as follows:

⁵³⁶ A Primary Contract is the contract dictating the rights and obligations of the parties which pertain to the supply of the equipment/technology.

⁵³⁷ In this case, X is the original seller, the supplier of the equipment/technology under the primary contract.

⁵³⁸ In this case, Y is the original buyer, the purchaser of the equipment/technology under the primary contract.

⁵³⁹ Products are the items or material sold and bought through the buy-back contract, produced by the equipment/technology from the primary contract.

Article I

The buy-back commitment

1.1. X⁵⁴⁰ hereby agrees to buy (or cause the purchase) from Y⁵⁴¹, under the terms and conditions set forth in this contract, products manufactured by Y using the equipment/ technology⁵⁴² sold by X, and take delivery of the said products.

1.2. Y hereby agrees to sell to X (or to his assignee⁵⁴³ (as defined below in Article 6)), under the terms and conditions set forth in this Contract, such Products, and to accept the purchase by X of such Products as buy-back within the framework of this Contract.

Article 2

The products

2.1. The assortment of products to be sold and purchased under this contract is agreed upon by the parties in accordance with the provision of article 10 below.

2.2. Y hereby warrants that sufficient products of the agreed assortment will be available at the times specified in article 10 of this contract.

Article 3

Conformity of the products

3.1. The products to be delivered shall correspond to the specifications and quality agreed upon in the primary contract, and must be of the quantity and assortment required by the individual purchase contracts (hereinafter “implementing contract(s)”⁵⁴⁴) to be concluded within the framework of this contract between Y or his assignee (as defined below in article 6) in his

⁵⁴⁰ In this scenario, X is the buy-back purchaser, who is the seller under the primary contract, in their capacity as buyer under the buy-back contract.

⁵⁴¹ In this case, Y is the buy-back seller, and therefore the buyer under the primary contract, in their capacity as seller under the buy-back contract

⁵⁴² Equipment/technology consists of the machinery, equipment, patents, knowledge, and/or technical assistance that will permit the production of the end product.

⁵⁴³ Assignee is the third party to whom the Assignor has transferred his rights and obligations under the buy-back contract.

⁵⁴⁴ The Implementing Contract is the contract specifying the rights and obligations of the parties with regard to the sale and purchase of products stemming from the buy-back agreement.

capacity of seller of the products (hereinafter “the implementing seller”⁵⁴⁵), and X, or his assignee (as defined below in Article 6) in his capacity of buyer of the products (hereinafter “the implementing buyer”⁵⁴⁶).

3.2. The products must be contained or packaged in the manner required by the respective implementing contract.

Article 4
Total value of the buy-back commitment

4.1. During the term of this Contract X shall purchase from Y Products for the value of either

- (A) ⁵⁴⁷ _____ OR
- (B) Not less than _____ per cent (_____ %) of the total _____ price of the primary contract as specified in Article X of the contract, plus not less than _____ per cent (_____ %) of the total price of the technical assistance invoiced in accordance with Article X of the technical assistance contract.⁵⁴⁸

4.2. The value of each of the implementing contracts to be applied against X's buy-back commitment under this contract shall be _____⁵ value of the respective Implementing contract.

4.3. The value of each of the implementing contracts, if invoiced in a currency other than the currency in which X's buy-back commitment is set forth here above, shall be applied against X's commitment at the exchange rate quoted by the central bank of _____⁵⁴⁹ at the date of the invoice issued in respect of such implementing contract.

⁵⁴⁵ The implementing seller is the supplier of the products under the implementing contract. This is ordinarily the original buyer under the primary contract and seller under the buy-back, but in some cases they may be a third party.

⁵⁴⁶ The Implementing Buyer is the purchaser of the products under the implementing contract. This is normally the original seller under the primary contract and buyer under the buy-back, but in some cases they may be a third party.

⁵⁴⁷ When alternative formulations comprise entire clauses, sentences, or half-sentences, the various alternatives are indicate with capital letters (A), (B), etc.

⁵⁴⁸ Indicate amount and currency.

⁵⁴⁹ Indicate name of the country.

Article 5

The price of the products will be either:

(A) 5.1 The prices of the Products offered under this Contract shall correspond to⁵⁵⁰

(1) The price generally charged at the time of the conclusion of the respective implementing contract for such products under comparable circumstances in the trade concerned.⁵⁵¹

(2) The fair average market value of the products in the territory (as defined below in pare. 7.1) under competitive terms of delivery and payment.

(3). The prices of competing products, of essentially similar specifications and quality standards than those of the products, in the territory (as defined below in pare. 7.1) under competitive terms of delivery and payment.

(4). The quotation of the product at the _____ exchange⁵⁵² on the date when the respective implementing contract is concluded.

(B) 5.1 The prices of the products shall be agreed upon from case-to-case by respective implementing seller and implementing buyer of the products;

(C) 5.1 X and the assignee(s) shall be granted most-favoured-customer conditions in the territory with regard to the products.

5.2. The prices of the products shall be quoted and paid for in _____⁵⁵³

⁵⁵⁰ A-1 to A-4 are optional reformulations of 5.1(A)

⁵⁵¹ The basis for this is Article 55 of the United Nations Convention on Contracts for the International Sale of Goods, 1980.

⁵⁵² Indicate the name of agreed commodity exchange.

⁵⁵³ Indicate currency.

Article 6

Assignment

(A) 6.1 X shall not be entitled to assign its buy-back undertaking under this Contract, either as a whole, or any part of it, to any other entity without the express written consent of Y.⁵⁵⁴

Such consent shall not be unreasonably withheld.

(B) 6.1 X may assign the whole, or a part, of its buy-back undertaking under this contract, to any third party

6.2. In the event that X (hereinafter “the assignor”⁵⁵⁵) shall assign any part of its buy-back commitment under this contract to a third party (hereinafter “the assignee”)

(A) all rights and obligations of the assignor under this contract with regard to the assigned part shall terminate at the time when the assignment contract between the assignor and the assignee becomes effective, and the respective rights and obligations shall be vested in the said assignee; provided that in the said agreement the assignee assumes all the obligations of the assignor agreed upon in this contract with regard to the part so assigned

(B) the assignor shall remain responsible, jointly and severally with the assignee, for the fulfilment of all of its obligations agreed upon in this contract.

6.3. X agrees to include in its agreement with any assignee appropriate provisions whereby the assignee commits itself to be bound by this contract with regard to the assigned part of the buy-back commitment, as if this contract had originally been executed by the assignee. In consideration for the said commitment, Y agrees to be bound by this contract against the respective assignee, with regard to the assigned part of the buy-back commitment, as if this contract had originally been executed with the assignee.

⁵⁵⁴ Replace "Y" with the name of the appropriate Government body in Y land, when applicable.

⁵⁵⁵ Assignor is the buyer or seller who has transferred their rights and obligations under the buy-back contract to a third party (the Assignee).

6.4. In the event that a party shall assign any part of its buy-back obligations under this contract to an assignee, it must give notice to the other party of the assignment. If the notice is not received by the other party within a reasonable time after the assignment, the party will be liable for the damages resulting from such non-receipt.

Article 7

Re-sale of the products

7.1. X or its assignee(s) shall have the right to re-sell the products in the territory agreed upon below in paragraph 7.2 (hereinafter “the territory”).

(A) 7.2. The territory shall include all countries in the world.

(B) 7.2 The territory shall include the countries set forth in appendix with respect to each of the products or product groups mentioned therein.

(C). X-land⁵⁵⁶.

7.3. The products shall not be re-sold outside the territory without the written consent of Y.⁵⁵⁷

7.4. It is agreed by the parties hereto that the restrictions set forth in paragraphs 7.2 and 7.3 above shall be construed as undertakings from the part of X or the Assignee, to refrain from actively putting the products in the market outside the territory.⁵⁵⁸

Article 8

Reference

Each implementing contract as may be entered into by a party or its Assignee in accordance with the terms of this contract, must explicitly refer to this contract and state that the said

⁵⁵⁶ This term denotes X-party's place of residence. In the case of a company, it is the place of registration.

⁵⁵⁷ Not applicable if alternative A is chosen.

⁵⁵⁸ Should be included if X land or any of the countries listed in Appendix are member countries of the European Economic Community (EEC).

implementing contract is made in fulfilment hereof. The parties agree to include in their agreements with any assignee appropriate provisions to that effect.

Article 9

Terms of delivery

Unless otherwise agreed in the individual implementing contracts, the terms of delivery of the products will be _____.

Article 10

Time schedules for performance

10.1. Deliveries of the products by Y will commence _____ days/months after the completion of the performance test and acceptance of the equipment/technology under the primary contract and the technical assistance contract.

10.2. It is presently estimated that the buy-back commitment agreed upon in article 4 above will be fulfilled according to the following schedule:

| Years | Value |
|-----------|-------------|
| 200 _____ | _____ |
| 200 _____ | _____ |
| 200 _____ | _____ |
| etc. | Total _____ |

10.3. Actual quantities and assortments of products to be delivered will be negotiated and agreed upon in the individual implementing contracts to be concluded not later than _____ days/months before the beginning of each year/quarter/month with regard to the said year/quarter/month.

10.4. When actual quantities and assortments are agreed upon, X's remaining buy-back commitment and X's own needs for products and prevailing market conditions in the territory for

the various assortments of the products will be taken into consideration. It is agreed, however, that, until the total buy-back commitment has been fulfilled, the value of products to be sold by Y and bought by X each calendar year will be at least _____ and not more than _____.

10.5. Sufficient Implementing Contracts to cover the whole of X's buy-back obligation as agreed under paragraph 4.1 above, must be concluded by _____ 200_____.

Article 11
Lack of conformity

11.1. X must examine the products delivered to him within as short a period as is practicable in the circumstances.

11.2. X loses the right to rely on a lack of conformity of the products if it does not give notice to Y specifying the nature of the lack of conformity within _____⁵⁵⁹ after it has discovered or ought to have discovered it.

11.3. Further rights and obligations of the parties with regard to the lack of conformity of the products will be governed.

- (A) By the provision of the law applicable to this contract.
- (B) By the provision of the guarantee conditions attached to this contract as appendix (), and by the provisions of the law applicable to this contract.

Article 12
Payment of the products

12.1. The Products shall be paid for in the currency agreed upon in paragraph 5.2 above, and in the manner set forth in paragraph 12.2 below.

⁵⁵⁹ Indicate time period.

12.2. Each delivery of the products shall be paid against the original documents set forth in paragraph 12.3 below.

(A) Through direct bank transfer to the bank account in Y land of the implementing seller of the respective products.

(B) through an irrevocable and transferable letter of credit, allowing partial and trans-shipments, to be opened in the amount of the respective implementing contract at the latest _____ days after the signing of the said contract, in the respective implementing seller's favour, and to be confirmed by the bank in Y land designated by the said implementing seller, such letter of credit to be valid for a period of _____ days/weeks/months after the agreed date of delivery of the respective products.

12.3. The products/letter of credit shall be payable against the following documents:

- _____.
- _____.
- _____.

12.4. The Implementing Buyer shall bear all exchange and bank charges as well as any other costs, including the confirmation charges of Letters of Credit but excluding the charges of the Bank of Y-land for transferring the funds to the Implementing Seller's account.

Article 13

Monitoring the performance

13.1. Both X and Y shall keep records on all implementing contracts concluded within the framework of this contract. Each such record (hereinafter “the evidence account”) shall be in the form set forth in appendix () to this contract.

13.2. The evidence accounts maintained by X and Y shall be compared and agreed by the parties through exchanges of letters on a quarterly basis during the term of this contract, the first occasion being no later than _____ 200_____.

13.3. X and Y hereby agree that the evidence accounts, compared and agreed in accordance with paragraph 13.2 above, shall constitute final and conclusive evidence as to the performance of their obligations under this contract.

Article 14

Liability

14.1. In the event that X's buy-back commitment, agreed upon in this contract, has not been fully performed by the date mentioned in paragraph 10.5 above, X shall, upon written demand by Y remit to Y as agreed and liquidated damages _____ percent _____%) of the value of the products yet to be purchased under paragraph 4.1 hereof.

14.2. Notwithstanding the provisions of paragraph 14.1 above, X shall not be obligated to make any payment mentioned therein insofar as the lack of performance of X's buy-back commitment is due to the failure of the implementing seller to deliver products of the quality, price or cumulative value specified in Articles 3, 5 and 10, respectively, of this contract.

14.3. If the lack of performance of X's buy-back commitment is due to the reasons set forth in paragraph 14.2, Y shall, upon written demand by X, remit to X as agreed and liquidated damages _____ per cent (_____ %) of the value of the products yet to be purchased under paragraph 4.1.

14.4. As guarantee for the due performance of its obligations under this article 14 X shall issue to Y a bank guarantee, acceptable to Y, for the sum of _____⁴. The bank guarantee shall be essentially of the form and contents as set forth in appendix () attached to this contract.

14.5. As a guarantee for the due performance of its obligation under this article 14 Y shall issue to X a bank guarantee, acceptable to X, for the sum of _____⁴. The bank guarantee shall be essentially of the form and contents as set forth in appendix () attached to this contract.

14.6. The payment by the respective party of the agreed and liquidated damages, set forth in paragraphs 14.1 and 14.3 above, shall be in full and final settlement of all claims that the other

party may have against the first party arising out of or in connection with the breach by the first party of his obligations under this contract.

Article 15

Relief

15.1. A party is not liable for a failure to perform any of his obligations if he proves that the failure was due to an impediment beyond his control and that it could not reasonably be expected to take the impediment into account at the time of the conclusion of the contract or to have avoided or overcome the impediment or its consequences.

15.2. Exemption under this article 15 shall be available to the affected party for the period during which the impediment prevents it from fulfilling his obligations under this contract. If the effect of the impediment lasts for more than _____ months, each party shall be entitled to terminate this contract upon written notice to the other, and neither party shall be liable to the other for any expenses or losses thereby incurred.

15.3. The party who fails to perform must give notice to the other party of the impediment and its effects on his ability to perform. If the notice is not received by the other party within a reasonable time after the party who fails to perform knew or ought to have known of the impediment, he is liable for damages resulting from such non-receipt.

15.4. A party may not rely on a failure of the other party to perform, to the extent that such failure was caused by the first party's act or omission.⁵⁶⁰

Article 16

The effect of the termination of the primary contract of the implementing contracts

16.1 In the event that the primary contract should subsequently be terminated without the equipment/technology having been transferred and accepted, this contract shall become automatically null and void and with no effect.

⁵⁶⁰ This Article is based on Articles 79 and 80 of the United Nations Convention on Contracts for the International Sale of Goods 1980.

16.2 For the purposes of this contract, X's buy-back commitment, agreed upon herein, or a respective part thereof, as the case may be:

(A) Shall be deemed fulfilled even if any implementing contract should later be terminated, through no fault on the part of X, for whatever reason.

(B) Shall not be deemed fulfilled insofar as any implementing contract should later be terminated, irrespective of the grounds for which the implementing contract was terminated. In this case X shall be obligated to conclude (a) fresh implementing contract(s) corresponding to the value of the terminated implementing contract(s) such fresh implementing contracts to be then carried out in accordance with the provisions of this contract.

Article 17

Prior commitments, effective date, amendments, and governing language

17.1. Except as otherwise expressly provided in this contract, this contract supersedes and invalidates all other commitments or representations which may have been made by X and Y either orally or in writing prior to the date of signature of this contract.

17.2. This contract shall come into effect only upon the entering into force of the primary contract and upon the signing of this contract by both parties and upon the approval of this contract by the competent authorities and/or financial institutions in Y land and/or X land. Y shall immediately notify X and X shall immediately notify Y by cable or telex of such approval, and the date of such notification, the latest of such notifications shall be the date on which this contract comes into effect. Unless the approvals are obtained within _____ days/months from the signing of this contract, it shall be considered null and void and with no effect.

17.3. Amendments to this contract will be effective only if they are made in writing and signed by legally authorized representatives of the parties, and if approved by the competent authorities and/or financial institutions in Y land and X land.

17.4. The _____⁵⁶¹ text of this Contract is the governing text.

Article 18

Applicable law

This contract shall for all purposes be governed by, and construed in accordance with, the law of _____⁵⁶²

Article 19

Settlement of disputes

19.1. All disputes or differences which may arise between the parties out of or in connection with this Contract, and which cannot be settled amicably shall be subject to arbitration by _____⁵⁶³ arbitrator(s) under the rules of _____⁵⁶⁴

19.2. The award of the arbitrator(s) shall be final and binding on the parties.

19.3. The arbitration proceedings shall be conducted in the _____¹⁶ language.

19.4. The place of arbitration shall be⁵⁶⁵ _____

| | |
|---------|--------------------|
| _____ , | _____ 200... _____ |
|---------|--------------------|

| | |
|---|---|
| X | Y |
|---|---|

| | |
|----------|----------|
| By _____ | By _____ |
|----------|----------|

⁵⁶¹ Indicate language.
⁵⁶² Indicate country.
⁵⁶³ Indicate number of arbitrators.
⁵⁶⁴ Indicate applicable rules.
⁵⁶⁵ Indicate place and country.

2. Overview of the Iranian Model Buy-back Contract

(Paydar West Field Asmari and Bangestan Reservoirs)
National Iranian Oil Company, South Fields (Year 1999)

Article 2

Scope of service

Contractor responsible to N.I.O.C. for operations and is to provide all capital, technology and skills necessary for the conduct of Development Operations for this Contract, and shall bear the Petroleum Costs required in carrying out Development Operations, and to recover such costs as provided in Clause 22 hereof, and bear the risks that sufficient production additional production of Crude Oil, and or Natural Gas may not be produced from the Contract Area in order to recover all such Petroleum Costs.

Article 3 – Term (Duration)

3.1. N.I.O.C. hereby authorizes Contractor to conduct development Operations in the end of the Development Phase in (To Be Negotiated) field. The conclusion of the Development Phase, under the Master Development Plan, for (To Be Negotiated) Field is (To Be Negotiated) months, unless extended by mutual agreement.

3.3. This Contract shall commence on the Effective Date, and shall continue through the Development Phase and thereafter until Contractor has recovered all Petroleum Costs and remuneration fee in accordance with Clause 22 ... which period shall not exceed (To Be Negotiated) years from the date on which ... Field has commenced first/additional production, unless extended by agreement.

Article 5 – Rights of NIOC

N.I.O.C. shall exercise all necessary control and supervision and has all rights to utilise the Contract Area for purposes not related to this Contract, except that such usage shall not prevent or hinder the carrying out of the Development Operations within the Field. N.I.O.C.s rights include inter alia:

(c) – Insurance

N.I.O.C. has the option to provide any legally required insurance coverage of materials and equipment, pursuant to Clause 12.

Article 6 – NIOC Assistance

6.1 Land and water reasonably required by Contractor for the purpose of Development Operations shall be acquired by the N.I.O.C. and put at the disposal of Contractor. The purchase prices shall be either paid by N.I.O.C. or included in the Petroleum Costs if paid by Contractor.

Article 7 – Rights and Obligations of Contractor

7.2 Contractor shall register a branch office in Iran for the purpose of following and complying with local laws.

Article 8 – Levies, Charges, Fees and Taxes

8.1 Any Iranian corporate income tax, Social Security Charges, or other levies imposed are payable by Contractor and an amount representing such charge shall be compensated by the N.I.O.C. to Contractor.

8.2 Contractor shall not be entitled to recover as Petroleum Costs⁵⁶⁶, and taxes charges, fees and levies upon its income levied outside of Iran nor any taxes, charges, fees and taxes of any nature that are paid directly by N.I.O.C.

Article 11 – Fixtures and Installations

11.2 – Ownership of Assets – All lands and assets acquired by the Contractor shall be the property of N.I.O.C., except for machinery and equipment imported on a temporary basis pursuant to provisions of clause 25 hereof.

Article 12 – Liability and Insurance

12.1 – Insurance – Contractor shall maintain insurance coverage in amounts required and N.I.O.C. may exercise the option to provide, at the Contractor cost, such coverage at rates not greater than market rates elsewhere⁵⁶⁷.

⁵⁶⁶ Article 8.2 sets a limit on the size of compensation by barring reimbursement for anything that is not “petroleum costs”, as per Articles 22. 1-4. It remains to be seen whether this element of the Model Contract may be overwritten by future amendments of the Majlis.

⁵⁶⁷ It is noteworthy that insurance contracts may only be signed with Iranian insurers.

Article 13 – Local Employment and Training

13.1 Contractor shall give priority to Iranian citizens in employment, or personnel to carry out the Development Operations, limiting the employment of foreign personnel to only positions where qualified Iranian citizens are not available.

In regards to the requirements set out in the above Article, it can be added that the foreign company is obligated to prove that a non-Iranian employee has skills that are not available on the domestic employment market. Additionally, it is mandatory for training to be provided to Iranians with the purpose of eventually substituting the foreign worker. A further requirement is that the foreign employer must, on a mandatory basis, donate a sum of money that is a certain percentage of the foreign worker's pay (which must be at least IR 560.00 (about US\$70), as of 2001)). With regard to the expatriate employees' legal status, they must acquire a work permit from the Department for Employment of Expatriates at the Ministry of Labour and Social Affairs (MLSA), as well as a simultaneously applied-for, one-year duration, renewable residence permit. If the company wishes to terminate their employment, they must navigate a complicated process, including a permission to terminate from the Labour Boards, which rarely favours the employer in their judgements.

Article 16 – Operator ship

16.1 N.I.O.C. shall be the operator for all facilities, immediately after commissioning and start-up.

Article 17 – Joint Management Committee

17.1 Joint Management Committee ("JMC") of five representatives from each party. N.I.O.C. shall function as the JMC Chairman until the end of the first year, and thereafter JMC chairmanship shall alternate between members annually.

Article 18 – Master Development Plan and Budget

18.1 Master Development Plan, including Work Programs and Budgets for the Development Phase I attached as Appendix "[...]". Capital Costs shall be equal to or less than (To be Negotiated) for the field to carry out the Development Operation, expended over (To Be Negotiated) years from effective date in the manner set out in more detail in Appendix "X". First

/ or additional production in the field is projected to occur within (To Be Negotiated) months after the Effective Date.

The amount is Sub-Clause 18.1 shall be the contracts ceiling, which shall not be increased.

Article 22 – Cost Recovery and Remuneration Fee

22.1 Contractor shall recover Petroleum cost, together with bank charges from the month the expenditure occurred at a rate equal to LIBOR plus/minus (To Be Negotiated) percent.

22.3 – Remuneration Fee – In addition to the Capital Costs, Non-Capital Costs, Bank Charges thereon and Operating Costs, Contractor shall be entitled to a remuneration fee of (To Be Negotiated⁵⁶⁸) US Dollars to be paid commencing the first month following the date of first/additional production from the field as follows: (To Be Negotiated)

In case of any changes required and approved by JMC in order to achieve the objectives of the Development Operations set forth in the original Master Development plan Contractor shall only be entitled to recover the additional related capital costs, resulting from all such approved changes up to the ceiling amount pursuant to clause 18.1 and subject to clause 18.3. In such case the Remuneration Fee shall remain fixed and unchanged.

22.4 – Payment in Oil – Petroleum costs and the remuneration fee shall be paid to the Contractor. Oil/gas out of (To Be Negotiated) percent of the product produced from the field and delivered to Contractor pursuant to the crude oil/gas sales agreement.

In the event that the petroleum Cost and Remuneration Fee are not fully paid during the Amortization Period, Contractor shall be entitles to receive Crude oil/Gas produced from the field as a result of Development Operation carried out by Contractor, pursuant to the Long Term Sales Agreement, until such Petroleum Costs and Remuneration fees are recovered, or the terms expires pursuant to clause 3.3.

Article 24 – Use of National Companies and Equipment

Contractor shall use the service of Iranian firms for the provisions of maximum utilization of Iranian content of the project with due regard to the laws of Iran.

⁵⁶⁸ As can be seen from the above, one problem with the reimbursement procedure is its dependence on negotiation, as the procedure itself is not clearly defined in the Model Contract. For instance, if delays occur, the foreign entity would ordinarily receive an interest payment on the sum owed. Such a mechanism, however, would be treacherous under Islamic law, which prohibits payment of interest.

Article 25 – Exports and Imports (Customs)

25.1. Materials and equipment are not available in Iran shall be imported in the name of N.I.O.C. Any customs duties shall be paid by the Contractor and shall be reimbursed as non-capital costs.

Article 27 – Assignment

27.1 Any assignment by Contractor shall require the prior written consent of N.I.O.C., and which shall be granted or refused within thirty days of receipt by N.I.O.C. of notice from Contractor that it intends to make such an assignment.

Article 31 – Governing Law

Contract governed, interpreted by the laws of Iran.

Article 32 – Arbitration

Any dispute, controversy or claim arising out of or relating to this contract or the breach, termination or invalidity thereof, shall be finally settled by arbitration before three arbitrators. Any award of the arbitrators shall be final and binding on the parties. Either party may seek execution of the award in any court having jurisdiction over the party against whom execution is sought.

APPENDIX “A” –Description of the Contract Area

APPENDIX “B” – Accounting Procedure

APPENDIX “C” - Long Term Crude Sales Agreement

Quantity

JMC under the Service Contract shall advise Seller (N.I.O.C.) and Buyer (Contractor) of the recoverable costs to be due to Buyer of the recoverable costs to be due to Buyer and the Service Contract (Service Contract Fees) during the next Quarter. Based upon the forecasted Service Contract Fees due to Buyer, Buyer shall furnish to Seller a statement of the volume of Crude Oil to be lifted in the lifting Quarter in order to compensate Buyer for the forecasted Service Contract Fees.

Payment

The Proceeds receivable by Seller under this Agreement shall be used to reduce the amounts owed to Buyer by Seller under the Service Contract and therefore no payments to Seller are required to pay Seller not post letters of credit or other guarantees of payment, relative to such deliveries, except as to any Crude Oil that Buyer may purchase from Seller in excess of amounts owed to Buyer under the Service Contract.

APPENDIX “D” – Agreement on Procedure for Arbitration

3 – The place of arbitration shall be agreed upon by the parties to the dispute. In the event that an arbitration site cannot be agreed upon prior to the appointment of a third arbitrator, then the arbitral tribunal shall, as its first act, convene in Tehran, Iran, to decide upon the site of arbitration.

4 – Each party shall appoint an arbitrator, and two arbitrators so appointed shall appoint a third arbitrator who shall act as chairman of the tribunal whom shall be from a country other than those of which the Parties are nationals.

11 – Referral of matters on dispute to arbitration by either party, shall if necessary to subject to the obtaining of the approvals of the appropriate authorities of the parties concerned.⁵⁶⁹

⁵⁶⁹ Ule & Brexendorff, op.cit., p39-40

